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FEDERAL ENERGY AND MINERAL RESOURCES ACT OF 1982

COMPLETED

ORIGINAL

HEARINGS

BEFORE THE

Y4.EN 2:97-97

COMMITTEE ON ENERGY AND NATURAL RESOURCES UNITED STATES SENATE

NINETY-SEVENTH CONGRESS

SECOND SESSION

ON

S. 2305

A BILL TO ENSURE THAT ALL ENERGY AND MINERAL RESOURCES ORIGINATING ON THE PUBLIC LANDS AND ON THE OUTER CONTINENTAL SHELF ARE PROPERLY ACCOUNTED FOR UNDER THE DIRECTION OF THE SECRETARY OF THE INTERIOR, AND FOR OTHER PURPOSES

MAY 3 AND 17, 1982

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FEDERAL ENERGY AND MINERAL RESOURCES ACT OF 1982

MONDAY, MAY 3, 1982

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, D.C.

The committee met, pursuant to notice, at 9:35 a.m., in room 3110, Dirksen Office Building, Hon. Malcolm Wallop, presiding.

Present: Senator Wallop.

Also present: Gary Ellsworth, counsel; Tony Bevinetto, professional staff member; Terri Sneider, counsel; D. Michael Harvey, chief counsel for the minority; and Craig Gannett, counsel for the minority.

OPENING STATEMENT OF HON. MALCOLM WALLOP, A U.S. SENATOR FROM THE STATE OF WYOMING

Senator WALLOP. Good morning, everybody. If any of us had the first grain of sense in our head, we would be outside having this hearing instead of inside.

I want to welcome and give thanks to all who have come here today to participate in the hearing on S. 2305. We will benefit from your views and recommendations on the bill to enhance the ability of the administration to collect royalties due from Federal and Indian mineral leases.

Although this is a hearing of the full committee, the two subcommittees having primary responsibility in this area are the Public Lands and Reserved Water Subcommittee which I chair, and the Subcommittee on Mineral Resources chaired by Senator Warner. The subcommittees are involved in royalty management oversight.

This payment of royalties, whether under or over, is a problem of long-standing concern. It has emerged as a national issue in repeated Government reports and audits over the past two decades. The General Accounting Office, the Interior Department's Office of the Inspector General, the U.S. Geological Survey, witnesses before this committee, and most recently the report of the Commission on Fiscal Accountability of the Nation's Energy Resources which was established to investigate allegations of massive irregularities in royalty payments due to the Federal Government have each documented serious defects in the Government's royalty collection system. The problems range from lost revenues estimated by some to be more than a million dollars a day, to outright fiscal theft of oil from Federal and Indian lands.

Problems stem in part from underpayments under an antiquated system of keeping accounts and from a failure to pay the full royalty amount due to accounting errors, mismanagement, fraud or theft in the field. If one considers that during 1981 the USGS collected a record high of $4.1 billion in royalties, including about $727 million in windfall profits tax revenues, one immediately senses just how high the stakes are when it comes to effective royalty management. With projections of $5 billion in royalties from the Federal and Indian leases in 1982 and perhaps as much as $14.6 billion by 1990, in time of budget cuts and belt tightening, it is more important than ever to insure that royalties are properly collected as a matter of equity and good government.

The bill before us today, S. 2305, proposes to cure some of these problems which I have mentioned primarily by putting enforcement teeth through the imposition of civil and criminal penalties into the royalty management law. The administration has in drafting S. 2305 followed most of the recommendations by the Linowes Commission for legislative action to cure the management ills of the royalty collection system.

However, I must emphasize that I do not necessarily endorse every provision of the bill. I am particularly concerned about provisions like section 12 which exceed the scope of the recommendations made by the Linowes Commission. We will closely scrutinize the bill and will, of course, welcome any comments on this or any provisions submitted for the record within the next 2 weeks.

I am also interested in the implementation of those Linowes Commission recommendations which did not require legislative remedies, and would ask the administration to provide for the record a progress report on any actions on those recommendations and any other actions or initiatives taken on their own, and not as a result of the Linowes Commission recommendations.

The committee would appreciate receiving for the record a report on how the Minerals Management Service was organized and how it was operating to date. I would be interested to know specifically how the lease management functions, exclusive of royalty management, are performed and by whom. Does the USGS perform resource evaluation and hazard analyses? In short, does USGS still have the responsibility for the scientific functions?

With that, I would make one additional comment. S. 2305 in part seeks to address a problem that has been identified and explored in a variety of places. In my opinion, it does not and should not stand as an accusation but merely as a means by which we get to a more efficient collection system, that reflects the economics of the oil and gas industry as it exists today, not the economics with $2-a-barrel oil and 25-cents-a-foot gas. Times have changed, and the only thing that did not change with them was the collection system, and obviously we have to in the interests of the Government do something about that.

The first witness this morning is Deputy Assistant Secretary Pendley, for Energy and Minerals, Department of the Interior.

[The text of S. 2305 follows:]

II

97TH CONGRESS
2D SESSION

S. 2305

To ensure that all energy and mineral resources originating on the public lands and on the Outer Continental Shelf are properly accounted for under the direction of the Secretary of the Interior, and for other purposes.

IN THE SENATE OF THE UNITED STATES

MARCH 30 (legislative day, FEBRUARY 22), 1982

Mr. MCCLURE (by request) introduced the following bill; which was read twice and referred to the Committee on Energy and Natural Resources

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A BILL

To ensure that all energy and mineral resources originating on the public lands and on the Outer Continental Shelf are properly accounted for under the direction of the Secretary of the Interior, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SHORT TITLE

SECTION 1. This Act may be cited as the "Federal Energy and Mineral Resources Act of 1982".

PURPOSE

SEC. 2. It is the purpose of this Act—

(1) to improve provisions of the mineral leasing laws related to obligations of lessees in the production of energy and mineral resources from the public lands and the Outer Continental Shelf;

(2) to clarify and reaffirm the authorities of the Secretary of the Interior to maintain properly a system of information regarding Federal energy and mineral resources in order for him to carry out effectively his duties under the mineral leasing laws; and

(3) to permit and encourage the development of enforcement practices to ensure prompt and proper collection of all mineral resources revenues owed to the United States and Indian lessors and those due to States in view of the significant Federal interest in assuring prompt and full collections of such royalties.

DEFINITIONS

SEC. 3. For the purposes of this Act, the term—

(1) "Federal land" means all land and interests in land owned by the United States which are subject to the mineral leasing laws, including mineral resources or mineral estates reserved to the United States in the conveyance of a surface or nonmineral estate;

(2) "Indian allottee" means any Indian for whom land is held in trust by the United States or who holds title subject to Federal restriction against alienation;

(3) "Indian lands" means any lands of an Indian tribe or individual Indian held in trust by the United States or which is subject to Federal restriction against alienation, but does not include any lands subject to the provisions of section 3 of the Act of June 28, 1906 (34 Stat. 539);

(4) "Indian tribe" means any Indian tribe, band, nation, pueblo, community, rancheria, colony, or other group of Indians, including the Metlakatla Indian Community of Annette Island Reserve, for which land is held by the United States in trust or which is subject to Federal restriction against alienation;

(5) "interest holder" means any person who holds any interest in a lease or who owes any royalty or other payment under any lease on the Outer Continental Shelf, Federal, or Indian lands;

(6) "lease" means any contract, profit-share arrangement, joint venture, or other agreement issued or approved by the United States under a mineral leasing law that authorizes exploration for and extraction and removal of a mineral resource;

(7) "lease site" means any lands or submerged lands on which exploration for and extraction and removal of a mineral resource are authorized pursuant to a lease;

(8) "lessee" means the person to whom the United States, an Indian tribe, or an Indian allottee issues a lease, or with whom the United States, Indian tribe, or Indian allottee enters into a contract, or, in the case of a lease or contract held by co-lessees, the one co-lessee designated prior to Secretarial approval of operations involving production by the co-lessees to be the "lessee" for the purposes of this Act;

(9) "mineral leasing law" means any Federal law or provision of Federal law authorizing the disposition under lease of mineral resources, including, but not limited to, the Mineral Lands Leasing Act of 1920, the Outer Continental Shelf Lands Act of 1953, as amended, the Indian Leasing Act of 1938, Reorganization Plan Numbered 3 of 1946, and the Surplus Property and Administrative Services Act of 1949;

(10) "mineral resource" means any mineral that is in or on the Outer Continental Shelf, Federal, or Indian lands where it is sought or found, subject to disposition under lease under any mineral leasing law;

(11) "Outer Continental Shelf" means all submerged lands lying seaward and outside of the area of lands beneath navigable waters as defined in section 2 of the Submerged Lands Act (Public Law 83-31) and of which the subsoil and seabed appertain to the

United States and are subject to its jurisdiction and control;

(12) "operator" means any person, including a lessee, who is responsible for the operations conducted on a lease;

(13) "production" means those activities which take place for the removal of minerals, including such removal, field operations, transfer of minerals off the lease, operation monitoring, maintenance, and workover drilling.

(14) "royalty" means any payment based on the value or volume of production which is due to the United States or an Indian lessor on production of minerals from the Outer Continental Shelf, Federal, or Indian lands.

(15) "Secretary" means Secretary of the Interior or his designee; and

(16) "State" means any State of the United States, the Commonwealth of Puerto Rico, the Virgin Islands, Guam, American Samoa, the Commonwealth of the Northern Mariana Islands, or the Trust Territory of the Pacific Islands.

SECRETARIAL AUTHORITIES

SEC. 4. (a) The Secretary may prescribe such rules and regulations as may be necessary or proper for the determination and collection of royalties on the production of mineral resources, the preparation and retention of records, the filing of reports, the conduct and frequency of audits, the enforcement of security at production sites and during the process of transporting mineral resources from such sites, and the imposition of penalties for failure to conduct properly such activities.

(b) Rules issued to implement this Act shall be issued in conformity with section 553 of title 5 of the United States Code, notwithstanding section 553(a)(2) of that title.

(c) In carrying out his functions under subsection (a) of this section, the Secretary may also—

(1) apply to any existing leases, permits, or applications for leases or permits issued under the mineral leasing laws such rules and regulations as may be promulgated under the authorities granted by this Act; and

(2) contract with such non-Federal Government inspectors, auditiors, enforcement officials, and other persons as he deems necessary to aid in the implementation of this Act in addition to entering into cooperative agreements as authorized under section 18 of this Act.

DUTIES OF INTEREST HOLDERS, LESSEES, OPERATORS, AND MOTOR VEHICLE TRANSPORTERS

SEC. 5. (a) Any interest holder of any lease on the Outer Continental Shelf, Federal, or Indian lands shall—

(1) make any royalty or other payments required under such lease, as specified by statute, regulation, order, or the terms of the lease, by the date specified in same, or within such time and manner as may be specified by the Secretary; and

(2) notify the Secretary, within such time and in such manner as the Secretary may specify, of any assignments he may have made of any interest in a lease, of his obligations and responsibilities for royalty payments under a lease, and of any recordkeeping or other obligation as may be imposed by the Secretary under the authorities granted by this Act or any other mineral leasing law.

(b) Any lessee carrying out production on the Outer Continental Shelf, Federal, or Indian lands shall develop and comply with a site security plan, in conformance with such minimum standards as the Secretary may prescribe, which will insure full accountability for mineral resources produced or stored on the lease site.

(c) Any operator carrying out operations on any lease site on the Outer Continental Shelf, Federal, or Indian lands shall—

(1) notify the Secretary on the first business day after any new well begins production anywhere on a lease site by such means as the Secretary may prescribe;

(2) prepare and maintain all records and, upon request by the Secretary, submit any such records to the Secretary, on the exact quantities of any mineral resource that is produced, stored, or removed from the lease site and the method by which such resource is removed; and

(3) provide the Secretary with any information the operator has concerning the selling or distributing of any mineral resource produced from the lease site.

(d) Any person engaged in transporting by motor vehicle any mineral resource from any lease site on Federal or Indian lands shall carry, on his person or in his vehicle, documentation showing from whom such mineral resource was obtained and from which lease site or unit it was produced.

HEARINGS AND INVESTIGATIONS

Sec. 6. (a) The Secretary may conduct any hearing, investigation, audit, inspection, or other inquiry necessary or appropriate to his royalty and other lease management functions. In connection with such hearing, investigation, audit, inspection, or inquiry, the Secretary shall also have the power—

(1) to require by special or general orders, any person to submit in writing such affidavits, reports, and answers to questions as the Secretary may prescribe, which submission shall be made within such reasonable period and under oath or otherwise, as the Secretary may determine;

(2) to administer oaths;

(3) to require by subpena the attendance and testimony of witnesses and the production of all books, papers, production and financial records, documents, matter, and materials, as the Secretary may request;

(4) to order testimony to be taken by deposition before any person who is designated by the Secretary and who has the power to administer oaths, and to compel testimony and the production of evidence in the same manner as authorized under paragraph (3) of this subsection; and

(5) to pay witnesses the same fees and mileage as are paid in like circumstances in the courts of the United States.

(b) The Attorney General or his designee, or a State or Indian tribe acting pursuant to cooperative agreement, may, in addition to any other remedies provided for in this Act, in any court of competent jurisdiction, initiate an action against any lessee, operator, or interest holder for an injunction to restrain any interference with the exercise of the right to enter or to conduct any activity authorized by this Act, or, in the case of a State or an Indian tribe, authorized pursuant to such agreement.

(c)(1) On any lease site of Federal or Indian lands, any authorized representatives of the Secretary, including any State or tribal law enforcement agency acting pursuant to a cooperative agreement, may stop or inspect any motor vehicle that they have probable cause to believe to be carrying a mineral resource and to lack the documentation required by this Act for the purpose of determining whether the driver has any such documentation.

(2) In any jurisdiction where there is in effect a valid State or tribal requirement that the driver of any vehicle carrying any mineral resource have documentation showing from whom the mineral resource was purchased and from which lease site it was produced, any authorized representative of the Secretary, including any State or tribal law enforcement agency acting pursuant to a cooperative agreement, may stop or inspect any vehicle that they have probable cause to believe to be carrying a mineral resource and to lack the docu-

mentation required by this Act for the purpose of determining whether the driver has any such documentation.

(d)(1) Authorized representatives of the Secretary, including any State or tribal enforcement official acting pursuant to a cooperative agreement, may inspect lease sites for the purpose of determining whether there is compliance with the requirements of this Act; site security plans, regulations, and standards developed pursuant to this Act; or with any citation, order, or decision issued under this Act. The right of inspection under this subsection shall be independent of, and supplementary to, any rights of inspection or entry possessed by the Secretary under existing or future leases.

(2) In carrying out the requirements of this subsection, no advance notice of an inspection must be provided to any person: *Provided*, That the Secretary shall develop guidelines setting forth the coverage and the frequency of inspections conducted pursuant to the inspection program which shall apply to all authorized representatives of the Secretary, including State and tribal enforcement officials acting pursuant to a cooperative agreement.

(3) For the purpose of making any inspection or investigation under this Act, the Secretary shall have the same right to enter upon or travel across any lease site as the lessee or operator has acquired by purchase, condemnation, or otherwise.

(e) In case of refusal to obey a subpena served upon any person under this section, the district court of the United States for any district in which such person is found, resides, or transacts business, upon application by the Attorney General at the request of the Secretary and after notice to such person, shall have jurisdiction to issue an order requiring such person to appear and give testimony before the Secretary or to appear and produce documents before the Secretary. Any failure to obey such order of the court may be punished by such court as a contempt thereof and subject to a penalty of $10,000 a day.

INJUNCTION AND SPECIFIC ENFORCEMENT AUTHORITY

SEC. 7. (a) In addition to any other remedy under this Act or any other mineral leasing law, the Attorney General or his designee may bring a civil action in the district courts of the United States, which shall have jurisdiction over such actions—

(1) to restrain any violation of section 14 of this Act; or

(2) to compel the taking of any action required by or under this Act or any other mineral leasing law of the United States.

(b) A civil action described in subsection (a) may be brought in the United States District Court for the District of Columbia or for the judicial district wherein the act, omission, or transaction constituting a violation under this Act or any other mineral leasing law occurred, or wherein the defendant is found or transacts business.

REQUIRED RECORDKEEPING

SEC. 8. In addition to the provisions of sections 5(c)(2) and 5(c)(3) of this Act, every person who is a mineral resource interest holder, lessee, or operator on the Outer Continental Shelf, Federal, or Indian lands, or is otherwise engaged in the business of developing, producing, transporting, marketing, or refining mineral resources produced on the Outer Continental Shelf, Federal, or Indian lands shall establish and maintain any records, make any reports, and provide any information as the Secretary may, by rule, require for the purposes of implementing this Act or determining compliance with rules or orders prescribed under this Act. Upon request of any officer or employee duly designated by the Secretary every such interest holder, lessee, operator, or other person shall permit the inspection of appropriate books, papers, financial records, production records, documents, matters, and materials.

OFFSHORE REFUNDS

SEC. 9. (a) Section 9 of the Outer Continental Shelf Lands Act, as amended (43 U.S.C. 1338), is amended by striking out section 9 and inserting in lieu thereof the following:

"SEC. 9. All sums paid to the Secretary under this Act shall be deposited in the Treasury of the United States and credited to miscellaneous receipts. This section shall not apply, however, to sums paid into the funds created by sections 302 and 402 of the Outer Continental Shelf Lands Act Amendments of 1978 (43 U.S.C. 1812 and 1842).".

(b) Section 10 of the Outer Continental Shelf Lands Act, as amended (43 U.S.C. 1339), is amended by striking out subsections (a) and (b), and inserting in lieu thereof the following: "The Secretary is authorized to refund or credit any overpayments deposited in the Treasury under section 9 of this Act. When the Secretary is satisfied that any person has paid more than he was lawfully required to pay, he shall refund or credit the excess, without interest, to the person or his legal representative. There are hereby appropriated to the Secretary out of any funds in the Treasury not otherwise appropriated such sums as are necessary for the refunds authorized by this section. To receive a refund or credit, a person must file a request with the Secretary within three years after making the payment.".

ROYALTY INTEREST, PENALTIES AND PAYMENTS

SEC. 10. The first sentence of section 35 of the Act of February 25, 1920, as amended (30 U.S.C. 191), is amended by inserting "including interest charges, and any other moneys, except civil penalty moneys, collected under the

Federal Energy and Mineral Resources Act of 1982, collected because of nonpayment, late payment or underpayment of royalties," between "royalties" and "and" and by deleting "as soon as possible" and inserting in lieu thereof "as often as administratively convenient but at least".

VALUE OF PRODUCTION FOR ROYALTY PURPOSES

SEC. 11. (a) The Secretary shall include gross proceeds received from the sale of production of any mineral resource from any lease on the Outer Continental Shelf, Federal, or Indian lands in valuing production for royalty purposes, notwithstanding any incentives or regulated price relief heretofore or hereafter granted to the producer by a regulatory agency.

(b) In valuing production for computing royalty, the Secretary shall not be bound by a prior valuation.

SECRETARY'S INDEPENDENT AUTHORITY TO COLLECT ROYALTY

SEC. 12. Notwithstanding any other provision of law, no provision of the Emergency Petroleum Allocation Act of 1973 or regulation by the Department of Energy thereunder concerning crude oil certification or pricing shall be deemed to apply to the Department of the Interior with respect to crude oil taken by the Department of the Interior in kind as royalty. No action shall lie against the United States or an official thereof arising out of any alleged failure of the Secretary to have properly certified or priced, under the Emergency Petroleum Allocation Act of 1973 or regulations thereunder, oil taken in kind as royalty by the Department of the Interior. No claim for a refund of alleged overcharges pertaining to the certification or pricing under the Emergency Petroleum Allocation Act of 1973 or regulations thereunder of oil taken by the Department of the Interior in kind as royalty shall give any right of action against the United States or any official thereof under section 210 of the Economic Stabilization Act, or any other provision of law.

EXPANDED ROYALTY OBLIGATIONS

SEC. 13. (a)(1) Section 8 of the Outer Continental Shelf Lands Act, as amended (43 U.S.C. 1337), is amended by inserting between the second and third sentence of subsection (a)(1) a new sentence to read: "Royalty and net profit share payment shall be due in amount or value of all production saved, removed, sold, used for exploration or production purposes, or lost or wasted from a lease: *Provided,* That no royalty shall be due on gas which is flared with prior approval from the Secretary.".

(2) Section 8 is further amended by deleting the words "saved, removed, or sold" in subsections (a)(1)(A), (a)(1)(B), (a)(1)(C), (a)(1)(F), and (a)(1)(G).

(b)(1) Section 17 of the Act of February 25, 1920, as amended (30 U.S.C. 226), is amended by adding a new sentence to the beginning of subsection (d) to read: "Royalty on all leases issued under this section shall be due in amount or value of all production saved, removed, sold, used for exploration or production purposes, or lost or wasted from a lease: *Provided,* That no royalty shall be due on gas which is flared with prior approval of the Secretary.".

(2) Section 17 is further amended by deleting the words "removed or sold" in subsections (b)(1), (b)(2), (c), (i), and (k)(1)(C).

PROHIBITED ACTS

SEC. 14. It shall be unlawful for any person to—

(1) fail or refuse to comply with any requirement prescribed by section 5 of this Act, any rule or regulation promulgated under section 4 of this Act, or any citation or order issued under this Act;

(2) prepare, maintain, or submit false, inaccurate, or misleading reports, notices, affidavits, records, data, or other information required by this Act;

(3) fail or refuse to permit entry, inspection, or audit, as required by section 6 of this Act;

(4) take, remove, or divert any mineral resource from any lease site on the Outer Continental Shelf, Federal, or Indian lands without having valid legal authority to do so or without paying full and proper royalty therefor;

(5) purchase, accept, sell, transport, or convey to another any mineral resource from any lease site on the Outer Continental Shelf, Federal, or Indian land, knowing or having reason to know that such mineral resource was stolen or unlawfully removed or diverted from such lease site; or

(6) misrepresent the nature or quality of any mineral resource transported by any means from any lease site on the Outer Continental Shelf, Federal, or Indian lands in any documents required by law or to any official charged with the enforcement of this Act which results in, or could result in, the underpayment of royalties.

CIVIL PENALTIES

SEC. 15. (a)(1) Any person who fails to comply with any provision of this Act or commits an act prohibited under section 14 shall be liable for a civil penalty of not more than $10,000 for each day such noncompliance continues.

(2) No penalty shall be collected until the person charged with a violation has been given an opportunity for a hearing. The Secretary may allow the person charged a reasonable opportunity to correct the violation.

(3) In determining the amount of such penalty or whether it should be remitted or reduced and in what amount, the Secretary may consider the nature, mitigating or aggravating

circumstances, extent and seriousness of the violation or violations and, with respect to the violator, the size of the business, the person's ability to pay, the effect on the person's ability to continue to do business, the person's history of previous violations, the degree of culpability, the person's demonstrated good faith in attempting to achieve rapid compliance after notification, if any, of the violation, and such other matters as the Secretary may deem appropriate.

(4) Upon administrative appeal or on his own initiative, the Secretary may compromise, reduce, increase, or otherwise modify, or remit, with or without conditions, any civil penalty which may be imposed under this section. The amount of such penalty, as finally determined, or the amount agreed to on compromise, may be deducted from any sums owing by the United States to the person charged. The Secretary in compromising, adjusting, or remitting any penalty under this section, may rely upon a summary review of the information available to him and shall not be required to make findings of fact concerning the factors listed in paragraph (3) of this section.

(5) Any person who has requested a hearing in accordance with paragraph (2) of this subsection within the time the Secretary has prescribed for such a hearing and who is aggrieved by a final order of the Secretary under this section may seek review of such order in the district court of the

United States of the judicial district wherein the violation took place or in the District Court for the District of Columbia: *Provided,* That review by the district court shall be only on the administrative record and not de novo. Such an action shall be filed within sixty days of the Secretary's final order.

(6) If any person or, in the case of a corporation or other entity, any officer or agent fails to pay an assessment of a civil penalty—

(A) after the order making the assessment has become a final order and if such person does not file a petition for judicial review of the order in accordance with paragraph (5), or

(B) after a court in an action brought under paragraph (5) has entered a final judgment in favor of the Secretary,

the court shall have jurisdiction to award the amount assessed plus interest from the date of the expiration of the sixty-day period referred to in paragraph (5) or the date of such final judgment, as the case may be. Judgment by the court shall include an order to pay.

(b) In addition to the penalty provisions above, the Secretary—

(1) may subject any lessee or interest holder to a penalty in the amount of three times the royalty due

but not paid after demand for royalty payment has been made; and

(2) may subject any operator who fails to comply with section 5(c)(1) of this Act to a penalty equal to the value of the total production between the date of required notification of the start of the new production and the date of actual notification.

(c) The Secretary shall charge interest on late royalty payments at a rate not less than the rate determined annually by the Secretary of the Treasury to be equal to the current average market yield on outstanding marketable obligations of the United States with periods of maturity of thirteen weeks, and adjusted to the nearest one-eighth of 1 per centum. This charge shall not be considered a penalty for purposes of this section.

CRIMINAL PENALTIES

SEC. 16. (a) Any individual or, in the case of a corporation or other entity, any officer or agent who knowingly or willfully violates any provision of section 14 of this Act shall be subject, upon conviction, to a fine of not more than $25,000 for each day of violation, or to imprisonment for not more than one year for each violation, or both, in addition to or in lieu of any civil penalty which may be imposed for such violation under section 15 of this Act.

(b) Any individual who knowingly and willfully authorizes or orders any of the acts or practices constituting, in whole or in part, a violation of section 14 of this Act, shall be subject to penalties under this section, personally and in addition to any penalties to which any corporation or other entity may be subject under section 15 of this Act.

(c) Any individual who has obtained possession of, or has access to, material the disclosure of which is prohibited by section 17 of this section, and who, knowing that disclosure of such material is prohibited, willfully discloses the material in any manner to any person not entitled to receive it, shall be guilty of a misdemeanor and fined not more than $25,000 or imprisoned for not more than one year, or both. Section 1905 of title 18, United States Code, does not apply with respect to the publishing, divulging, disclosing, or making available information reported or otherwise obtained under this Act.

PROPRIETARY AND TRADE SECRET INFORMATION

SEC. 17. Trade secret, proprietary, or other privileged information obtained by the Secretary pursuant to this Act shall be exempt from disclosure under the provisions of section 552 of title 5, United States Code. The Secretary shall, by regulation, prescribe standards for identifying information as trade secret, privileged, or proprietary.

COOPERATIVE AGREEMENTS

SEC. 18. (a) The Secretary is authorized to enter into a cooperative agreement with any State to share minerals royalty management information in a timely manner and on a regular basis, to secure information for the cross checking of company submitted data, to carry out inspection and auditing activities in cooperation with, and under delegated authorities from, the Department, and to carry out any other activity described in subsection (b), (c), and (d) of section 6 of this Act. The Secretary shall not enter into any such cooperative agreement with respect to any such activities on Indian lands, except with the permission of the Indian Tribe involved.

(b) The Secretary is authorized to enter into a cooperative agreement with any Indian tribe to share minerals royalty management information, in a timely manner and on a regular basis, to secure information from tribes for cross-checking company submitted data, to carry out certain inspection and auditing activities in cooperation with and, under delegated authority from, the Department.

(c) Any cooperative agreement entered into pursuant to this section shall be in accordance with the provisions of the Federal Grant and Cooperative Agreement Act of 1977, and shall contain such terms and conditions as the Secretary deems appropriate and consistent with the purposes of this

Act, including, but not limited to, a limitation on the use of Federal assistance to those costs which are directly required to carry out the agreed upon activities.

(d) The United States shall not be liable for the wrongful disclosure by any State or Indian tribe of any information provided to such State or Indian tribe pursuant to any cooperative agreement authorized by this section.

RELATION TO OTHER LAWS

SEC. 19. (a) The authority to regulate and supervise mineral resource lease operations vested in the Secretary by this Act shall supplement any authority otherwise vested in the Secretary by the specific mineral leasing law under which specific leases are issued and maintained. In case of conflict between the provisions of this Act and any mineral leasing law, the provisions of this Act control. The civil and criminal penalty provisions of this Act do not affect the Secretary's authority to assess penalties under any mineral leasing law, or to enforce the regulations or terms of leases or contracts by cancellation, specific performance, or other remedy authorized by law.

(b) No provision of this Act shall be construed to mean that the authority of the Secretary mentioned in such provision did not exist before the enactment of this Act.

FUNDING

SEC. 20. Effective October 1, 1982, and notwithstanding any other provision of law, there shall be deducted from royalty collections an amount not to exceed one percent of royalties estimated to be collected by the United States pursuant to the mineral leasing laws, after payments of windfall profit taxes. A proportionate amount of the total royalty collected from each royalty source shall be deducted prior to any division and distribution of such royalties to the States, Indian tribes, and individual Indian allottees, or the Treasury, and the sums so deducted shall be deposited in the Treasury as miscellaneous receipts. The amount of the deductions shall be calculated to equal the amount appropriated for royalty management activities, adjusted to compensate for prior year differences between appropriated amounts and amounts deducted.

For purposes of this section, the following activities shall be considered royalty management activities: accounting, auditing, product valuation, data collection, regulation writing, enforcement, and engineering technical support.

STATEMENT OF WILLIAM P. PENDLEY, DEPUTY ASSISTANT SECRETARY FOR ENERGY AND RESOURCES, DEPARTMENT OF THE INTERIOR, ACCOMPANIED BY ALEXANDER H. GOOD, ASSOCIATE SOLICITOR, ENERGY AND RESOURCES

Mr. PENDLEY. Thank you, Mr. Chairman. I have here with me Alex Good, who is our Associate Solicitor for Energy and Resources.

Mr. Chairman, I appreciate the opportunity to be here this morning to speak with regard to S. 2305. I have provided the subcommittee with a copy of my prepared testimony, but I wish to speak extemporaneously regarding this discussion on S. 2305 and the activities that we have taken since we received the Linowes Commission report on the 19th of January of this year.

Mr. Chairman, I noted as I entered, that Chairman Linowes will be testifying this morning, and I would like to reiterate again the testimony of Secretary Watt that he has made on numerous occasions regarding the great debt that we and the American people owe to Chairman Linowes for the outstanding service that he and the other Commission members performed for the country and the entire effort in which they engaged to provide for the American people a compilation of an understanding of the royalty management system here in the United States.

As you know, Mr. Chairman, there have been reports and documents and studies done for over 20 years regarding this issue, and unfortunately, until the present administration, no Secretary of the Interior had the courage, as Chairman Linowes has pointed out, to take hold of this sensitive issue and to deal with it expeditiously.

Mr. Chairman, I won't list the activities in which the Department engaged prior to the appointing of the Linowes Commission in July 1981 or the activities in which we engaged during the exercise of the ongoing activity of the Commission. Those, that very lengthy summary of activities and initiatives, were provided for this subcommittee when Secretary Watt testified in late January of this year.

What I should discuss, however, are the activities that we have taken since the receipt of the Linowes Commission report. We have moved aggressively in an effort to implement the various recommendations of the Commission, to meet or to exceed the goals of the various recommendations with regard to our internal operations, with regard to site security, with regard to the royalty management system, across the breadth of the tremendous area covered by that outstanding document which frankly we have used as our guiding principle in developing our new system.

Secretary Watt has personally engaged in a number of these activites. The Secretary signed a letter to some 2,300 operators and lessees on public, Federal, and Indian lands advising them of his intention to hold them primarily responsible for site security. We have required as an element of the application for permit to drill process that we be notified on the first day of the production that a well on a particular leasehold has gone into production.

We have directed all of our field personnel to engage in firm but fair enforcement of the various rules and regulations existent with regard to site security and with regard to royalty management.

We have conducted for the first time in the history of the old Conservation Division, now the Minerals Management Service, a very extensive training course for our petroleum engineering technicians (PET's) in Colorado. We plan to have another session of that training exercise to insure that all of our PET's are informed and up to date on the actions that we will undertake.

In addition, I have traveled personally to Denver to speak to those technicians to advise them that they have the full and complete support of the Secretary and of the Department of the Interior to be aggressive in the enforcement of our rules and regulations out on the Federal estate.

We plan as well to insure that there is consistency in the application of our rules and procedures, to have in our supervisors, the district supervisors, the people who are the bosses of these individuals who are in the field, to insure that they are well aware of our orientation and of our attitude to be tough with regard to site security and good engineering practices enforcement on Federal leases.

We have engaged in a look-back audit exercise with the Inspector General in the Department of Interior. We are now engaged in the process of doing a careful audit of our major companies, 25 of which account for 85 percent of the royalties that we receive, and over the next 2 years we will have initiated the rest of these audits. We are seeking funding to permit us to engage in that effort.

In addition, Mr. Chairman, as you know better than most, we have engaged in a cooperative audit exercise, and our first initiative in that area was with the State auditor of Wyoming, Jim Griffith. It was an initiative of yours and the Secretary's, and Mr. Griffith's, to engage in that audit and it has been extremely successful. We have collected so far some $3.5 million. We expect to collect up to $9 million. We have letters out in that amount for a total expenditure on our part of some $34,000, so we think that is an excellent cost/benefit ratio.

In addition, we have as a result of the Wyoming initiative received requests from other States to come and join us in those audits, including the State of New Mexico, the State of North Dakota, and interestingly enough, the State of California which originally had sued the Federal Government to collect these royalties. California has now come in and said maybe we can find the money in a better way. Maybe we can work together to find these backpayments, so we are very pleased with that program. We expect that we will have more States shortly. I think Montana has just recently come in. In fact, I think that document has been signed. As well we have opened up discussions with Indian tribes to engage in a similar effort on the Wind River Reservation.

Mr. Chairman, we have previously prepared a detailed listing of the 60 recommendations and the specific actions that we have undertaken with regard to each recommendation, and we will be glad to supply that document for the record, Mr. Chairman. I think that you will agree that it has been an exciting demonstration of the aggressive approach that we have taken with regard to these recommendations which were delivered to us as we remember just a few months ago on the 19th of January.

I would like to respond briefly to the request you made, and certainly we would be glad to provide more for the record, but I think it is important to move off on a tangent slightly here to address the question of the Minerals Management Service.

The Minerals Management Service is simply the entire Conservation Division moved conceptually off to the side, reporting through a new director rather than the Chief of the Conservation Division, reporting through an active director and directly to the Undersecretary on the Minerals Management Board. The Conservation Division has no less and no more of the responsibilities which have always been given to the Conservation Division, so MMS has all of those responsibilities—the leasing functions, the onshore activity, the offshore activity, the prelease functions that are performed by the Conservation Division in assistance to the Bureau of Land Management, and the Forest Service and BIA as well, and those postleasing functions in which MMS/CD once engaged, and continue to engage. There has been no change in those activities, no increase in responsibilities, simply the continuation of those activities that have long been those of the Conservation Division.

We have seen no breakup and no inhibition of our ability to do the job, to make sure that the mineral resources that the American people demand to return America to its greatness are made available and done in a sensitive and effective fashion, so we are comfortable with the way the Minerals Management Service is operating.

What we have done simply is strike the line that reads USGS and insert in lieu thereof Minerals Management Service, and those are the natures of the cooperative agreements with the Bureau of Land Management, BIA, the Forest Service, and so forth. It is functioning very, very well, and we look forward to a successful several months until the Secretary makes his final decision with regard to what constitutes the Minerals Management Service and in fact how leasing functions are performed in the Department in December of this year.

Mr. Chairman, we have supplied to this committee on the 25th of March a very comprehensive legislative package of which we are quite proud. We are proud from one narrow aspect, and that is the timing in which we were able to get this product to you. We were informed of the Secretary's decision on the 19th of January, and on the 25th of March, just a little over 2 months later, we had a document up here. I don't know if we broke any records in doing so, but I don't think we could have done a better job in any faster time than we did.

As you know, Mr. Chairman, this legislation does represent some 19 to 20 of the various recommendations of the Linowes Commission, and I think it is a very good document. It is a narrow document insofar as what it tries to do. I think that the risk would be that we reach too far in our regulatory zeal to insure that the problem is taken care of, but we have been very careful in our exercise in our seeking of legislative authority.

Mr. Chairman, we should have provided you a section-by- section analysis of that document. We will have that section-by-section analysis up to you before the morning is out, perhaps in the first of the afternoon, but we will have that document to this committee so that you can be sure of what we are asking for and that we have used the precise language that is necessary to achieve our objectives.

Senator **Wallop**. I would cite from the standpoint of one whose job it is to try to conduct a hearing with some sense of what it is that you all have on your mind, it is very much more helpful to have that before the hearing starts instead of in the afternoon after it is over with.

Mr. **Pendley**. Yes, sir. I appreciate that. Mr. Chairman, we apologize for our negligence in not having that document to you.

Mr. Chairman, that concludes my remarks. I am pleased to be here this morning, and to be able to respond to your questions, and I would urge, Mr. Chairman, that action be taken expeditiously on this legislation. I know your time is short, as is ours, and we would hope that we would have a bill for the President's signature before the end of this Congress.

Thank you, Mr. Chairman.

[The prepared statement and section-by-section analysis submitted by Mr. Pendley follows:]

STATEMENT OF WILLIAM P. PENDLEY

Deputy Assistant Secretary for Energy and Minerals

DEPARTMENT OF THE INTERIOR

BEFORE THE SENATE ENERGY AND NATURAL RESOURCES SUBCOMMITTEE

PUBLIC LANDS AND RESERVED WATER

May 3, 1982

Mr. Chairman, it is my great pleasure to represent the Department of the Interior regarding the Federal Energy and Minerals Resources Act of 1982--S. 2305. As you know Mr. Chairman, that proposal represents the legislative elements of the recommendations of the Commission on Fiscal Accountability of the Nation's Energy Resources as presented to Secretary Watt on January 19, 1982. It is the culmination of eight weeks of intensive effort on the part of the Administration to conceptionalize, to verbalize and to fine tune a legislative document. I don't know if we set any records in the process, but I can't imagine delivering a better product in less time than this Administration took. There can be little doubt after that effort as to the seriousness of this Administration regarding the matter of royalty collection.

At this time Mr. Chairman, I would like to extend the Department's appreciation to you, Senator McClure, and the Staff of the Senate Energy and Natural Resources Committee for the expedited action taken regarding the Administration's proposed Energy and Mineral Resources legislation. Since the Secretary's appearance before the Senate Energy and Natural Resources Committee in January, the Minerals Management Service has been aggressively implementing the 60 recommendations of the Linowes Commission report. Many have been instituted or commenced adminstratively, or are contained in S. 2305, while several others are being studied by the Department. The first recommendation to be implemented was the major organizational realignment recommended by the Commission. On January 19, Secretary Watt established the Minerals Management Service with the mandate to improve the management of, and provide greater management oversight and accountability for, the mineral related activities previously carried out by the Conservation Division of the Geological Survey, while moving aggressively with the Secretary's energy and minerals program.

Through the realignment of the management structure, we are developing new or vastly improved programs including tighter internal controls, stricter inspection and enforcement policies, revamped auditing procedures, additional penalties, and expanded cooperation with States and Indian tribes.

Key among the internal controls is our program for verification of production and sales using well test data, run tickets, and meter readings to cross-check production reports. Also, we are incorporating into our royalty management activity a system for automatic identification of late payments or nonpayments with immediate followup procedures. Other elements of our strengthened internal control program include routine audits as well as look-back audits to identify present and past royalties owing.

The inspection and enforcement policies charge all lessees and operators with responsibility for security on Federal and Indian lease sites. An active Federal enforcement program will assure that the site security and production report responsibilities are carried out in a satisfactory manner.

Broadened cooperative relationships with the States and Indian tribes are already producing substantial benefits to the public. Joint audit agreements have been entered into with several States, and extensive information sharing programs are being developed. For example, as a result of a joint audit conducted with the State of Wyoming, significant royalty revenues were identified as not accounted for and immediately due.

S. 2305 is an integral part of the MMS efforts to improve its management and royalty collection responsibilities. It reaffirms and strengthens the Secretary's authorities, imposes specific duties and responsibilities on interest holders, lessees, operators, and motor vehicle transporters and most improtantly, ties noncompliance of these authorities and responsiblities to civil and criminal penalties. In addition, S. 2305 would strengthen the Secretary's audit and investigating functions and provide authority to enter into cooperative agreements with States to carry out many of the responsiblities of the Secretary. Finally, it would include a number of technical amendments that would make the valuation and distribution of royalties easier. This is the legal teeth we need to conduct a better royalty management program.

Mr. Chairman, allow me to conclude by bringing this Committee up to date on an administrative action recently taken by the Department. As you know, for the past 3 months, I have served as Acting Director of the Minerals Management Service at Secretary Watt's personal request pending the appointment of a permanent Director. Recently I reported to the Secretary that I had fulfilled the recommendations of the Commission and put them in place in the Department's system. It was my belief that only two tasks remained--naming of a permanent Director and passage of this legislative effort. The Secretary asked that I devote myself to fulfilling those two remaining issues. I have done so and expect we will have a new Director in a matter of weeks. In order that I might complete those two tasks and in order that I might fulfill my numerous other responsibilities as Deputy Assistant Secretary—including the President's Minerals Policy--I asked that another Acting Director be named to meet the day-to-day administrative demands of the Mineral Management Service. Secretary Watt has thus named William D. Bettenburg, Deputy Assistant Secretary for Policy, Budget, and Administration, to serve as Acting Director. We are pleased to have Bill on board.

Mr. Chairman, this is a vital element of our effort to return the confidence of the American people to the royalty management program. I urge the prompt action of the U.S. Senate.

I would be pleased to answer any questions.

Section by Section analysis of the Administration's proposed "Federal Energy and Mineral Resources Act of 1982".

Section 1. SHORT TITLE

The short title of this Act is the "Federal Energy and Mineral Resources Act of 1982".

Sec. 2. PURPOSE

This legislation is proposed by the Administration in order to ensure prompt collection of royalties, to hold lessees accountable for the obligations they undertake when they hold a lease, to institute an effective civil penalty system to deter theft of mineral resources and to clarify and reaffirm the authority of the Secretary to assure full receipt of royalties.

Sec. 3. DEFINITIONS

This section defines the terms used throughout the Act.

Sec. 4. SECRETARIAL AUTHORITIES

Subsection (a) authorizes the Secretary to prescribe regulations concerning the determination and collection of royalties on mineral resources, the preparation and retention of records, the filing of reports, the conduct and frequency of audits, the enforcement of security of mineral resources at production sites and during the process of transporting the resources from such sites, and the imposition of penalties for failure to conduct properly these activities. The authority granted under this subsection to regulate off-lease transportation ends when the production has been delivered to a common carrier, except as provided in section 5(d).

Subsection (b) requires that these regulations be issued in conformity with the Administrative Procedure Act.

Paragraph (1) of Subsection (c) authorizes the Secretary to apply these regulations to existing leases, permits and applications for leases and permits.

Paragraph (2) authorizes the Secretary to contract with non-Federal inspectors, auditors, enforcement officials and other persons to aid in the implementation of the Act.

Sec. 5. DUTIES OF INTEREST HOLDERS, LESSEES,OPERATORS, AND MOTOR VEHICLE TRANSPORTERS

Subsection (a) sets forth the duties of the interest holders of leases on the OCS, Federal and Indian lands. Paragraph (1) reaffirms the duty of all interest holders to make royalty and other payments required under the lease as specified by a statute, regulation, order, and by the date specified in the lease or within a manner and time specified by the Secretary. This requirement applies to all payments which the interest holder is required to pay under statute, regulation, or order as a result of his interest in the lease. Paragraph (2) requires the interest holder to notify the Secretary of any assignments the interest holder may have made of any interest in a lease, and of his obligations and responsibilities under any lease. Notification of an interest holder's obligations under a lease shall include any notification of compliance with any other obligation imposed on him by regulation or otherwise under authority of the Act or any other mineral leasing law.

Subsection (b) sets forth certain duties of lessees on the OCS, Federal, and Indian lands. Under this subsection, lessees would be responsible for development of, and compliance with, site security plans that would have to meet certain minimum standards prescribed by the Secretary.

Subsection (c) sets forth certain duties of operators on lease sites on the OCS, Federal and Indian lands. Under paragraph (1), operators would be required to notify the Secretary (by such means as the Secretary may prescribe) on the first business day after any new well on a lease begins production. Paragraph (2) would require that operators prepare and maintain records on the quantities of any mineral resource that is produced, stored, or removed from the lease and the method by which the resource is removed. Finally, paragraph (3) would require lease operators to provide any information they have concerning the selling or distributing of mineral resources produced from the lease site (e.g. division orders).

Subsection (d) sets forth duties of motor vehicle transporters of mineral resources from leases. They are required to carry with them, when transporting a mineral resource from a Federal or Indian lease site, documentation showing from whom the mineral resource was obtained and from which lease site or unit it was produced.

Sec. 6. HEARINGS AND INVESTIGATIONS

Subsection (a) authorizes the Secretary to conduct any hearing, investigation, audit, inspection, or other inquiry necessary or appropriate to his royalty and other lease management functions. The Secretary is also empowered to require certain information to be submitted in writing, to administer oaths, to require by subpoena the testimony of witnesses and the production of materials, to order depositions, and to pay witnesses.

Subsection (b) authorizes the Attorney General or his designee to initiate an action for an injunction to restrain any interference with the exercise of his right to enter or to conduct any activity authorized by the Act. States and Indian Tribes, if acting pursuant to a cooperative agreement, would be authorized to initiate similiar actions.

Subsection (c) authorizes any authorized representative of the Secretary to stop and inspect on any Federal or Indian lease lands any motor vehicle that he has probable and appropriate cause to believe to be carrying a mineral resource and to lack the documentation required by section 5(d) for the purpose of determining whether the driver has such documentation. He may also stop and inspect vehicles off the lease if the vehicle is in a jurisdiction that requires documentation as required in section 5(d). States and Indian Tribes are given the same authority if they are inspecting pursuant to a cooperative agreement.

Subsection (d) gives the Secretary authority to inspect lease sites for the purpose of determining whether there is compliance with the requirements of the Act. This right of inspection is independent of, and supplementary to, any right of inspection or entry possessed by the Secretary under other laws or lease terms. Although no advance notice need be given of such inspections, the Secretary must develop certain guidelines for conducting the inspections and those guidelines shall apply to Federal officials and States and Indian tribes conducting inspections pursuant to cooperative agreements. The Secretary shall have the same right to enter upon or travel across any lease site as the lessee or operator. This inspection authority is given to States and Indian Tribes inspecting or investigating pursuant to a cooperative agreement. This section shall not apply to the Inspector General of the Department of the Interior who derives his authority under the Inspector General Act of 1978.

Subsection (e) provides that failure to comply with a subpoena pursuant to this section subjects the failing person to contempt in District Court and to a penalty of $10,000 a day.

Sec. 7. INJUNCTION AND SPECIFIC ENFORCEMENT AUTHORITY

Subsection (a) authorizes the Attorney General or his designee to bring a civil action in Federal district court to restrain any violation of section 14 or to compel the taking of any action required by this Act or any other mineral leasing law.

Subsection (b) states in which Federal district courts such an action may be brought.

Sec. 8. REQUIRED RECORDKEEPING

Section 8 requires any person who is an interest holder, lessee, or operator on the OCS, Federal, or Indian lands or is otherwise engaged in the business of developing, producing, transporting, marketing, or refining mineral resources from such lands to establish and maintain any records, to make any reports, and to provide any information that the Secretary may, by rule, require. These persons must also permit the inspection of certain information and materials by the Secretary.

Sec. 9. OFFSHORE REFUNDS

Subsection (a) amends section 9 of the Outer Continental Shelf Lands Act and requires the Secretary to deposit all sums paid to him under the Outer Continental Shelf Lands Act to be credited to miscellaneous receipts in the Treasury of the United States except sums paid into sections 302 and 402 funds.

Subsection (b) amends section 10 of the Outer Continental Shelf Lands Act, concerning refunds and credits when a person has made any overpayment in excess of that lawfully required, by expanding from two to three years the time in which any such person must request repayment of such excess, and by allowing the Secretary to refund or credit the amount of overpayment from the Treasury and by removing the requirement that a report concerning such refund be sent to the Congress and await thirty days before any such refund is made.

Sec. 10. ROYALTY, INTEREST, PENALTIES AND PAYMENTS

Section 10 amends section 35 of the Act of February 25, 1920 (30 U.S.C. 191) by including any interest charges or other monies (other than civil penalties) collected under this Act among the monies proportioned and distributed to the States and by allowing for the distribution of royalties to the States more often than two times a year.

Sec. 11. VALUE OF PRODUCTION FOR ROYALTY PURPOSES

Subsection (a) directs the Secretary to include gross proceeds received from the sale of production for royalty purposes, notwithstanding any incentives or regulated price relief granted to the producer by a regulatory agency, such as the Department of Energy. In the past, when the Department of Energy (DOE) granted price relief, such as upper tier or tertiary incentive, the DOE refused to allow royalty interest owners, including the United States, to value production for royalty purposes by including the gross proceeds accruing to the producer. DOE would specifically order the producer to pay royalty as if the production were sold at the applicable regulated price. The Department of the Interior, on the other hand, stating that the Mineral Lands Leasing Act and OCS Lands Act require royalty to be assessed on the "value of the production," has required such producers to include the gross proceeds in the value of the production as required by Interior Department regulations. This subsection resolves a longstanding problem in royalty management and provides direction to producers caught between conflicting orders.

Subsection (b) provides that, in valuing production for computing royalty, the Secretary shall not be bound by a prior valuation. If the Secretary has not previously set or authorized a reasonable unit value for production from the lease, the Secretary may apply his finding of proper and lawful value retroactively. If the Secretary has previously set or authorized a reasonable and lawful unit value for production, the Secretary may change his order, but may do so only prospectively. This subsection would apply to existing and future lease, regardless of whether deposit of royalty payments has been made without objection.

Sec. 12. SECRETARY'S INDEPENDENT AUTHORITY TO COLLECT ROYALTY

Section 12 provides that all sales of royalty oil pursuant to any mineral leasing law shall be deemed to have been properly certified for purposes of the Department of Energy's Mandatory Price Regulations.

Geological Survey, when the Secretary elects, takes the United States royalty share in kind rather than in money. The price Geological Survey charges purchasers of the royalty oil is the same the lessees receive for like oil from the same lease. Thus Geological Survey endeavors to realize the same cash value from the sale of royalty oil as it would from receiving the royalty share in money directly from the lessee. The Department of Energy had rules which required the price certification of all first sales of production within a 60 day period. (10 C.F.R. 212.131). Failure to certify timely or properly resulted in the sale of oil being automatically deemed as lower tier or old oil, even if the oil were actually upper tier, stripped production, or other exempted production.

Because of the royalty accounting procedures used, Geological Survey would first find out whether oil was upper or lower tier from the lessee's monthly production reports -- typically 40-45 days after the month (or 30 day period) in which the oil was produced, and sometimes as late as 70 days after royal oil sales. As a result, the actual billings to royalty oil purchasers often occurred, necessarily, after the certification period imposed by Department of Energy regulations.

Several royalty oil purchasers are now seeking refunds of part of their purchase price. Their main allegation is not that Geological Survey sold old oil at new oil prices but that, because of the procedural deficiencies in price certification, all sales must be deemed as lower tier. They seek refunds equal to the difference between what they paid for their oil and the deemed lower tier price.

It is doubtful that Congress ever intended to expose the United States to such refund suits under section 210 of the Economic Stabilization Act, 12 U.S.C. 1904 note, particularly its treble damages provisions. See S. Rep. No. 92-507, 92d Cong. 1st Sess. (1971) reprinted in U.S. Code Cong. & Admin. News at 2283, 2291.

Sec. 13. EXPANDED ROYALTY OBLIGATIONS

Section 13 amends the Outer Continental Shelf Lands Act and the Act of February 20, 1920, to require that royalty and net profit share payment due on Federal offshore and onshore leases be paid on all production saved, removed, sold, used for exploration or production purposes, or lost or wasted from a lease. This assures that the United States receives royalty from all mineral extraction and mineral use activities on the lease by the lessee. This would assure full royalty from the minerals owned by the United States and would assure responsible extraction techniques and full accounting for the mineral resources of a lease. No royalty will be due on gas which is flared with the prior approval of the Secretary.

Sec. 14. PROHIBITED ACTS

Section 14 lists prohibited acts. This includes the failure or refusal to comply with the duties listed in section 5 or the rules issued under section 4; the preparation, maintenance or submission of false, inaccurate or misleading information required by the Act; the failure or refusal to permit entry, inspection, or audit; the taking, removal or diversion of any mineral resource from a lease without valid legal authority or without paying proper royalty for it; the purchase, acceptance, sale, transporting or conveyance to another of a mineral resource when one knows or has reason to know that it was stolen or otherwise unlawfully removed; and, finally, the misrepresentation of the nature or quality of any mineral resource taken from a lease in any required documents or to any official charged with enforcement of the Act.

Sec. 15. CIVIL PENALTIES

Subsection (a) sets forth the civil penalty system of the Act. Under paragraph (1), any person who fails to comply with the Act or who commits a prohibited act listed in section 14 shall be subject to a civil penalty of not more than $10,000 for each day of the violation.

Paragraph (2) provides that no civil penalty can be collected until the person charged has been given an opportunity for a hearing. The Secretary has the discretion to allow the person a reasonable opportunity to correct the violation before assessing and collecting the civil penalty.

Paragraph (3) lists a number of factors that the Secretary may consider in determining the amount of a penalty and whether it should be remitted or reduced and in what amount.

Paragraph (4) authorizes the Secretary to modify any civil penalty imposed under the Act. The amount charged may also be deducted from any sums that the U.S. might owe to the person charged (e.g. an income tax refund). The Secretary is not required to make findings of fact concerning the factors listed in paragraph (3), but may rely on a summary review of the information available to him.

Paragraph (5) authorizes any person aggrieved by a final order of the Secretary to seek review of that order in a district court of the United States. However, that review shall be on the administrative record only and shall not be de novo. Request for such judicial review must be within 60 days of the Secretary's final order.

Paragraph (6) gives the district court jurisdiction to award the amount assessed plus interest and to issue an order to pay if any person fails to pay an assessment of the civil penalty after a court has entered a final judgment in favor of the Secretary or, in the case where the person does not file a petition for judicial review, after the final order of the Secretary.

Subsection (b) authorizes the Secretary to subject any lessee or interest holder to a penalty of three times the royalty due but not paid after demand for royalty payment has been made and to subject the operator who fails to provide first business day notification of production to a penalty equal to the value of the total production between the date of required notification and that of actual notification. These penalties are in addition to any assessed under subsection (a)(1).

Subsection (c) directs the Secretary to charge interest on late royalty payments at a rate equal or to higher than the quarterly per centum rate of funds published by the Treasury Department. The charging of interest shall not be considered a penalty for purposes of section 6.

Sec. 16. CRIMINAL PENALTIES

Subsection (a) subjects any individual or, in the case of a corporation or other entity, any officer or agent who knowingly violates the provisions of section 6 to a criminal penalty of not more than $25,000 for each day of the violation or to imprisonment for not more than a year for each violation, or both. Criminal penalties under the Act may be charged in addition to or in lieu of any civil penalties charged under the Act.

Subsection (b) provides that any individual director, officer, or agent of a corporation who willfully authorizes, or orders, any violation of section 6 of the Act shall be subject to a criminal penalty personally in addition to any penalty to which the corporation or other business entity is subject. The standard of proof for conviction under this section is intended to be higher than that required by subsection (a).

Subsection (c) provides that any individual, including a State or tribal agent, who obtains or has access to material the disclosure of which is prohibited under section 12 and who knowing that disclosure is prohibited, willfully discloses it, shall be subject to a criminal penalty of not more than $25,000 and up to one year in prison, or both. This penalty is in lieu of and higher than the penalty in section 1905 of title 18 of the United States Code for the disclosure of confidential information.

Sec. 17. PROPRIETARY AND TRADE SECRET INFORMATION

Section 17 exempts trade secret, proprietary, or other privileged information obtained by the Secretary pursuant to this Act from the disclosure requirements, or voluntary agency disclosure notwithstanding exemptions (1) through (9) of 5 U.S.C. 552(b), under the Freedom of Information Act. The Secretary is also directed to prescribe standards for identifying information as trade secret, privileged, or proprietary.

Sec. 18. COOPERATIVE AGREEMENTS

Subsection (a) authorizes the Secretary to enter into cooperative agreements with States to share minerals royalty management information, to secure information for the cross checking of company-submitted data, to carry out inspection and auditing activities, and to carry out the other authorities listed in certain subsections of section 6. The Secretary is not authorized to enter into these agreements with States in respect to Indian lands unless he has the permission of the tribe involved.

Subsection (c) provides that these cooperative agreements will be in accordance with the provisions of the Federal Grant and Cooperative Agreement Act of 1977 and there shall be a limitation on the use of Federal assistance to those costs which are directly required to carry out the agreed upon activities.

Subsection (d) provides that the United States will not be held liable for the wrongful disclosure by any State or Indian Tribe of any information they obtain pursuant to a cooperative agreement.

Sec. 19. RELATION TO OTHER LAWS

Subsection (a) states that the authorities vested in the Secretary under this Act are supplementary to the authorities vested in the Secretary in the mineral leasing laws. In case of conflict between a provision of this Act and a provision of any mineral leasing law, the provision of this Act controls. The civil and criminal penalty provisions of this Act do not affect, limit, or restrict the Secretary's authority to assess penalties under any mineral leasing law or to enforce other regulations or terms of leases or contracts by cancellation, specific performance or other remedy authorized by law. No provisions of this Act should be construed to limit the authorities of the Inspector General under the Inspector General Act of 1978.

Subsection (b) provides that no authority given to the Secretary in this legislation shall be construed not to have existed in the Secretary prior to enaction of the legislation. Because the Secretary has existing authority in most matters covered by this Act, but may not have authority to impose certain penalties as provided in this Act, this subsection assures and maintains the Secretary's existing authority under other mineral leasing laws.

Sec. 20. FUNDING

Section 20 provides that one percent of the royalties collected by the Secretary from leases on the Outer Continental Shelf, Federal or Indian lands, before division and distribution of such royalties and after payment of windfall profit taxes, shall be deducted from royalty collection for the Secretary's royalty management activities.

Senator **Wallop**. I might just say for those who plan to submit testimony, the record is officially open for the 2 weeks, but anybody who has comments that they wish to make, if they could get them in early, it would be helpful in the likelihood of meeting the deadline which the committee is faced with.

Mr. Pendley, several sections of S. 2305 provide some concern, but several provisions in there which provide for retroactive relief to the Department of the Interior raise a special concern.

Would you or your legal counsel address these and explain why they would not be unconstitutional, especially sections 11 and 12?

Mr. **Pendley**. Mr. Chairman, although I am an attorney, I don't wear an attorney's hat at the Department. I try to wear a policy hat and try to refrain from making legal pronouncements. Let me speak specifically with regard to one concern that we had that relates to retroactive application, and that was with regard to first day notification.

We do have a provision I think in section 4 that relates to Secretarial authority to promulgate regulations, and we did seek and will insure, Mr. Chairman, some retroactive authority there. We were careful in drafting the legislation to insure that it was retroactive only with regard to this act and not retroactive with regard to changes in something like the 1920 Mineral Leasing Act, for example.

Senator **Wallop**. How do you draw that distinction?

Mr. **Pendley**. Well, we state specifically in section 4 that with regard to achieving the purposes of this act so we could think, for example—let me give my specific illustration of that. Specifically with regard to first day notification, it was the conclusion of the Linowes Commission that one of the problems that the Minerals Management Service has that the Government has is that we don't know when the first day of the next month arrives when those royalties will be coming in. We don't know when a well has gone into production on which we will be receiving royalties.

As a result, the Linowes Commission recommended that we obtain first day notification of that well going into production. We have done that prospectively with regard to changes in the application for permit to drill process, and I have issued an order to all regional managers in all of our regions to do so. However, we are limited, as you know, with regard to what we can require of existing lessees who have not yet gone into production. In anticipation of that, we sought at least in this one instance, that retroactive application.

Senator **Wallop**. On the other side, does it relieve the Department of its potential liability? One side is retroactive, and the other side is relief, and I am just curious as to why that appears to be equitable.

Mr. **Pendley**. Mr. Chairman, certainly it is relief from the negligence of the Government over the past 20 years to be strict in its enforcement of its responsibilities to insure full and accurate collection of royalties. We are being relieved of that failure and of that negligence, but I think the purpose is served by the goal that we have and a narrow application of the legislation to insure that we are aware in this instance that we are taking about the instance of a well going into production and the due date coming up the following month.

Senator WALLOP. Certainly you are relieving yourself from liability to finance as well, and I just don't see the equity that exists. I mean it seems to me that the best thing to do is having admitted what we will find out probably from other testimony, but having admitted that the whole thing has been not well done to date, why don't we start on the date when everybody decides it is going to be well done and each State be as accountable to the new process as the other?

Mr. PENDLEY. The only problem we have there, Mr. Chairman, is the fact that we do have about, as I recall, the figure 2,300 APD's now outstanding. The APD has been issued. The people are out there. We think they are getting ready to drill, but they have no requirement to report to us, to give us first day notification. We have changed all our APD's since about the first week of February, but with regard to those applications for permit to drill that have already been issued, how do we pull them in on that first day notification? That was the authority that we sought here in this section.

Senator WALLOP. Well, that is section 4?

Mr. PENDLEY. Yes, sir, section 4.

Senator WALLOP. But sections 11 and 12 are the ones that are of concern, too.

Mr. PENDLEY. With regard to section 11——

Senator WALLOP. Twelve especially.

Mr. PENDLEY. With regard to section 12, the Department of the Interior has taken the position that we were not required to issue the certifications that were engaged in by the Department of Energy when that certification process came in conflict with the responsibilities of the Secretary to insure the collection of the full and adequate royalty. That is the position that the Department of the Interior took, the position that aspect of the Government has maintained, and we are seeking to have the Congress to put in legislation, to put in statute, the position that we have maintained on this issue.

Senator WALLOP. To move on a little bit, the Interior Department is just one of a lot of Government agencies who are subject to mandatory petroleum price regulation.

Can you explain to this committee why it would be, why the Federal Government should be entitled to preferential treatment in the form of an absolute exemption from liability for overcharges and why, for example, States like Texas and Louisiana and the city of Long Beach would not be entitled to a similar exemption?

Mr. PENDLEY. Mr. Chairman, we do have some important responsibilities under the act to collect the full fair market value of these other royalties for the royalties of the product, and it was the conclusion of the Department of the Interior that those statutory requirements came in conflict with the certification requirements under the Department of Energy, and as a result, because we could not comply with both, because they were mutually exclusive, the Department of the Interior took the position that it should comply with the collection of the royalties aspect of that question. That is the position the Department has maintained, and we seek the enactment of legislation that would adopt that position.

Senator **Wallop**. I think you will find that others will feel similarly constrained in the way they have been forced by regulation and law to comply, and it seems peculiarly arrogant to remove one section of Government because it happens to be the biggest and apply it to all other Government because they happen to be smaller, and that just, I guess I just don't understand that as a matter of equity. If it is using one sauce for the geese, then that certainly is good for the gander. Wouldn't that be reasonable?

Mr. **Pendley**. With regard to the matter of equity, Mr. Chairman, to restate, we felt constrained by the two directions that we were receiving, one direction from the statutory responsibilities with regard to Federal lands and royalty collection on those lands, and on the other hand, the statutory direction with regard to the Emergency Petroleum Allocation Act. Given what we saw as a conflict between those and our ability to enforce both, we chose to enforce the one that was specifically applicable to the Secretary.

Senator **Wallop**. I think you will probably have to look at that. There is another area in which I will submit some questions for the record in the interest of time here this morning.

Undervaluation of royalties was one of the major problems identified by the Linowes Commission and by the GAO in its report on present failures of the system.

Why does S. 2305 not address or provide a definition for the fair market valuation of leaseable minerals?

Mr. **Pendley**. Mr. Chairman, we believe that that is unnecessary. The value on which the royalty is assessed is the value of the product in the marketplace. We have recently had a situation in the Department of Interior, and perhaps this is apropos to your question, a number of companies made contracts to supply natural gas at a rate that at the time seemed reasonable. It was a 21 cents per Mcf rate in the Gulf of Mexico. As you know, Mr. Chairman, the price of natural gas is no longer anywhere near 21 cents per Mcf, and in fact the Natural Gas Policy Act provided that it be much higher than that.

Unfortunately, the Federal Government has been collecting the royalty at 21 cents per Mcf even in the face of a fair market value of what is essentially, $3 and $4 natural gas. The Inspector General conducted an audit of that practice of the Department of the Interior and came to the conclusion, as did the Solicitor's Office, that we were in fact undervaluing that gas for the purpose of royalty collection.

It was the recommendation of the Inspector General and the Solicitor's Office that we collect the royalty on the natural gas at market rate. As a result, we have had hearings on the issue. We have sent out Federal notice on the issue, and we have assessed the companies involved a royalty during those years for the fair market value of that gas. This is a substantial bill, Mr. Chairman, as you can appreciate. We are collecting something, we would be collecting if they concurred with our assessment, some $50 million in one case and $35 million in another. This is an example of our effort to assess royalty on fair market value, and we think that the fair market value, of course, is defined in other areas in other legislation, in the statute under which we operate, so we don't seek a new definition of that question here.

Senator **Wallop**. Well, it might provide some reassurance for those who would have to comply with it that there was a consistency in the application of the term "fair market value," and I guess I have no quarrel with what you say, but it seems that if I were on the other side and trying to comply, I would be much happier if I knew that it was going to apply the same to me as it was to somebody across the way in another section.

Mr. **Pendley**. Mr. Chairman, it is an excellent question, and it is one of the specific concerns the Linowes Commission had with our procedures, the Government's procedures. In regard to the conflicting signals that the private sector has received from the Government with regard to fair market value, the Linowes Commission specifically recommended that we seek out means of setting exactly what those fair market value prices are and providing solid signals to the industry so that they might respond one way or the other with regard to our calculation of values.

We are engaged now in a process of attempting to set that out, and you know from your experience with the Natural Gas Policy Act how difficult that is for us to do, but we are engaged in that process so that we might put to an end the conflicting signals that the private sector received from the Government.

Senator **Wallop**. Why is it that the bill only addresses itself to oil and gas and not other leaseable minerals—coal, uranium, phosphate or other?

Mr. **Pendley**. Mr. Chairman, we do not believe that it does. We have used, as I recall, the words energy resources. I think they are the words that we used—mineral resources—and we sought to use that to insure that we can apply these concepts overall. The Linowes Commission in the conclusion to their report said well, we have examined the question of oil and gas in this exercise. We have not investigated coal and other resources, but the problems may lie there as well. Out of concern that they may well be there, we have sought the authority to apply this concept across the board to those other mineral resources that are issued by lease.

Senator **Wallop**. It does appear to do that, but then you get down to section 5(c)(1), those provisions require that the Secretary be notified on the first business day for any new well that begins production anywhere on the lease site, which would appear to limit those reporting requirements to oil and gas leases and thereby shielding other operators, lease operators, of other kinds of minerals from similar reporting requirements.

Mr. **Pendley**. It does appear to do that, Mr. Chairman. Perhaps what we need is a change in the statutory language.

Senator **Wallop**. I think what I will do in the interest of time and the other people's desire to testify and be heard is to submit some questions for the record which we can provide you most of this afternoon.

Mr. **Pendley**. Mr. Chairman, we have thought carefully about most of these issues, I think all of the issues, and we would be able to be responsive to you almost immediately, as soon as you get those questions up to us. I know the fast track on which you are engaged. We will get them back to you and be responsive so you might move quickly with your markup.

Thank you for the opportunity to be here, Mr. Chairman.

Senator WALLOP. Now the next witness is Mr. Linowes, former Chairman of the Commission on Fiscal Accountability of the Nation's Energy Resources. Welcome once again.

Mr. LINOWES. Thank you, Mr. Chairman. With your permission, for the record I would like the written testimony to be part of the record, and I would just like to comment on certain portions of it.

Senator WALLOP. I appreciate that. Thank you, sir.

STATEMENT OF DAVID F. LINOWES, FORMER CHAIRMAN, COMMISSION ON FISCAL ACCOUNTABILITY OF THE NATION'S ENERGY RESOURCES

Mr. LINOWES. I certainly want to express to you, Mr. Chairman, particularly, my personal appreciation for the expeditious manner in which this bill has moved through the early legislative processes. As we all know, enactment of this legislation would do much to implement those recommendations of the Commission that require legislative action.

I have to stress again as I have before you on previous occasions, Mr. Wallop, how pleased I am, and I am sure all of the members of the Commission are, with the enthusiastic and prompt acceptance of all the recommendations in our report by Secretary Watt. It is most gratifying to all of us to observe that kind of reaction.

There is no need for me to dwell with you on the extent of the losses that appear to have been suffered by the Federal Government, Indians and States, merely to add to that that since the Commission's report, the very prompt and enthusiastic implementation of so many of our recommendations, lease reviews and internal audits have revealed continuing and even larger efficiencies that have come to our attention during the deliberations of the Commission. We heard of at least two of them from Mr. Pendley who has done a very effective job in designing a structure for the implementation of those recommendations that did not require legislation.

I think I can be best helpful to you at this time to address S. 2305 in particular. On previous occasions and for the record I have spelled out the various elements of the recommendation and the need for it. It is very urgent in my judgment that this legislation continue to move as expeditiously as possible because there are some very serious problems that cannot be resolved without legislation. I think what we have to do is to run through those areas of our report that in our judgment require legislation, and then briefly comment on whether or not S. 2305 does that.

We felt that the purchasers of energy resources from Federal and Indian lands should be required to submit reports to Federal managers. That is not just a clerical exercise. That purchaser's report is a very critical dimension for internal control. Many of the deficiencies that came to light came to light as a result of variations between what was reported to the Government as the basis for calculation and what was actually sold during the same period from the results of producing that at a particular well site. We believe it is quite obvious that section 8 can handle that, but it would have to be implemented by regulation. That is, the very specific direct implementation of that.

Another very important recommendation is that truck holders of oil in particular from Federal and Indian leases carry run tickets. Again, it is not a clerical document. It is a very key document to assure that, as you know, that the contents of that tank truck in the case of oil is in the proper stream of commerce and that is something that has been stolen and not reported. We feel it is important that the Federal inspector stop trucks and check run tickets, and the one factor that I think more than anything else that triggered the creation of this Commission was the fact that Charles Thomas did stop a truck and find there wasn't a run ticket, and the kind of exposure that that received brought considerable attention to this issue, and he, of course, had no authority to stop that truck, so it is very important at least that people have authority to stop the truck at least on Federal and Indian lands.

There is still the question of on State highways, but cooperation with the States, of course, will help resolve that.

A very important item which was touched on in the bill but would have to be implemented a little more strongly and perhaps by regulation has to do with the prohibition of the purchase of undocumented oil and requirement of criminal penalties. You have that type of penalty in most other areas, but for some reason the legislation traditionally has not required that kind of penalty, and again I think it can be applied by regulation pursuant to section 14.

We feel that there should be authorization for civil penalties for site security violations, for nonpayment, for late payments, for error ridden reports, and for failure to comply in general with many of the provisions. That might seem an obvious fact, but the fact of the matter is that it has not been so in regulation on implementation, and that is stated very clearly in the act.

The carryon of this work in cooperation with States and Indian tribes you heard from Mr. Pendley the great success that we are already having just with the very prompt and ad hoc, informal agreement between Governor Herschler of Wyoming and Secretary Watt and the joint oil team made up as I understand it of only four auditors from the State of Wyoming, but you will hear more about that from the Federal Government, and that is clearly in the act.

Another point which we believe to be important is that there be a self-sustaining fund to finance supplemental audits, inspections. This is not in the act. The section 20 deals with special assessment, and it is across the board, and in my own personal judgment, it is appropriate. There is no reason why the Indian tribes and the States should not help participate in some extent for the administration of the collection of royalties, and those funds pass to the Federal kitty rather than collect gross royalties, but it does not implement our recommendations. We felt it was very important that there be a special fund that would be under the control of the Secretary.

Now I do understand, and I saw the draft of the bill made, inquiring from those involved in the design of the bill, that there may be some question, some political plus management questions. It is a question whether Congress would give up that authority.

The way we would recommend it is that Congress not really have any authority over this fund once it is collected, but you do need that kind of flexibility it would seem to us.

Another area that we suggested that the Federal Government be permitted to share in, in the interest of fairness, is interest and penalties paid for late payments and underpayments. The bill only suggests sharing of interest and not penalties, and I am told that it had to be so because there is no precedent for the sharing of the penalties, but again, these are technical points that we can accept or not accept, but I do think the expeditious moving of this legislation is very critical.

We have recommended the amendment of the Outer Continental Shelf Lands Act to allow prompt refund of any overpayments. We feel industry was placed at an unreasonable burden in trying to collect overpayments on offshore leases, and we felt that should be corrected. That is in the act.

We also have recommended, and we thought required, legislation that the Federal royalty managers be relieved of the obligation to calculate and pay the windfall profits tax. I am told the Department is pursuing that, but it would be handled in another manner in perhaps separate legislation.

Mr. Chairman, I appreciate very much the great problems in designing this legislation, and the difficulty in trying to catch all the problems. I do think this is especially good legislation. I think it would permit the kind of administration that royalty collections which stand at $5 billion this year, running to as much as $15 billion by 1990 deserve, and it should be so designed that it can be handled in a businesslike manner and under a responsible administrator and, of course, Congress can hold that administrator to his duties.

It is that section 20 that is the major difference. There is another item that is in the bill, and that is section 5(a)(2) that seems to be at variation with our recommendations and that section deals with the duties of interest holders, lessees, operators, and motor vehicle transporters. The relevant portion states that—

> Any interest holder of any lease shall notify the Secretary within such time and in such manner as the Secretary may specify of any assignments he may have made of any interest in the lease of his obligations and responsibility for royalty payments under the lease.

The Commission has recommended that the function of keeping track of several hundred thousand payers is a heavy and unnecessary burden which Federal royalty managers should not have to carry, and we had urged on pages 50 and 51 of our report that the Department should require that lessees require a payer plan identifying all payers and their interest for each lease, and that the plan be continually kept up to date, and it should be the responsibility of the lessee or his agent to notify the Department of any changes made in payer responsibility.

Right now the Government does not know how many fractionalized lease owners they don't know about. They have established their records based on their receiving almost voluntarily a check, as you know, from the fractionalized lease purchaser, and it is the judgment of the Commission as expressed in the report, the strong feeling in unequivocal terms that the lessee should be held responsible for keeping tabs on making sure that proper notification is given to the Department.

In spite of a couple of observations I have made, I would strongly urge the adoption of this bill because I know how bills can be delayed once you go into trying to work through too many fine modifications. It seems to me broad enough and adaptable enough and is the type of legislation that could substantially strengthen the hand of any conscientious, effective administrator.

I think with that observation I will stop and be pleased to elaborate on any other points or any questions.

[The prepared statement of Mr. Linowes follows:]

TESTIMONY OF
DAVID F. LINOWES, FORMER CHAIRMAN
COMMISSION ON FISCAL ACCOUNTABILITY
OF THE NATION'S ENERGY RESOURCES
BEFORE THE
COMMITTEE ON ENERGY AND NATURAL RESOURCES
U.S. SENATE
SENATOR JAMES A. McCLURE, CHAIRMAN
MAY 3, 1982

Mr. Chairman and Members of the Committee, thank you for inviting me to appear at this hearing to discuss with you Bill S. 2305, the "Federal Energy and Mineral Resources Act of 1982."

At the outset, I would like to express my appreciation for the expeditious manner in which this bill has moved through the early legislative processes. Enactment of the legislation will do much to implement those recommendations of the Commission on Fiscal Accountability of the Nation's Energy Resources requiring legislative authority. As a participant in the design of those recommendations, it is most gratifying.

All the Commissioners are also particularly pleased with the enthusiastic, prompt acceptance and implementation by Secretary Watt of all those recommendations that do not require legislation. The steps he has taken together with S. 2305, we are convinced will bring effective financial management to our Nation's energy resources.

As you know, on January 21, 1982 the Commission completed its six-month investigation of royalty management for oil and gas produced from Federal and Indian lands, and submitted its report to President Reagan and Secretary of the Interior James Watt. That report concluded the Federal Government has been mismanaging royalty collections for over 20 years. As a result, the U.S. Treasury, the Indian tribes and states have been losing hundreds of millions of dollars in oil and gas royalties.

Because the Government's royalty records are in disarray, it is not possible to give an exact figure for royalty underpayments. We believe the estimate of 7 to 10 percent underpayments, which was cited in the 1979 report of the General Accounting Office, is a reasonable one, given the fact that the Government's royalty system lacks the most elementary controls. The handful of major audits that have been conducted in the past have revealed significant underpayments.

It is even harder to estimate the losses due to theft. Some industry officials and oil field security experts believe that 3 to 6 percent of oil production is being stolen. We do know for a fact that security at many Federal and Indian lease sites is lax and is an open invitation to theft.

The Commission found that royalty collection is essentially on the honor system. The U.S. Geological Survey, which has managed royalties since 1925, takes the word of the companies that lease Federal and Indian lands as to how much oil and gas they produced and how much the product is worth. The USGS does not verify independently the amount of production; it rarely checks company statements on the value of the product; and it does not even compare on a routine basis the companies' production reports with their sales reports.

Moreover, USGS royalty records are in such disorder that the agency cannot tell which companies have paid and which have not. When the Government has discovered instances of gross underpayment of royalties, or of serious repeated violations of the rules for lease site security, penalties have been light or nonexistent.

In the months just prior to the establishment of the Commission, the U.S. Geological Survey had begun taking steps to improve royalty management. The agency planned to install a fully computerized system to keep track of royalty payors, and also had planned to include some computerized checks of company reports in the new system. Most of the controls have yet to be designed, however, and no phase of the new system is yet in full operation.

THE COMMISSION'S INVESTIGATION

It might be useful for me at this point to outline how the Commission carried out its assignment. In our six months of existence, we consulted as widely as possible with all those particularly interested in Federal royalty management. Among the witnesses appearing before the Commission were present and former top officials of the U.S. Geological Survey and other officials of the Department of the Interior, including the Inspector General. We heard from the General Accounting Office, the Internal Revenue Service, and the Federal Bureau of Investigation.

Representatives of seven Indian tribes (Osage, Shoshone, Arapahoe, Blackfeet, Ute Mountain Ute, Jicarilla Apache, and Spokane Tribes, and the Association of Wind River Allottees) and the Council of Energy Resource Tribes appeared before the Commission. So did officials of seven of the twenty-three states which receive a half share of Federal royalties on minerals produced from onshore leases within their borders. These seven states -- Wyoming, Utah, California, South Dakota, Colorado, New Mexico, and Louisiana -- received 87 percent of the royalty shares paid to states by the Federal Government last year.

Officers of six major oil and gas companies (Conoco, El Paso Natural Gas, Exxon, Getty, Gulf and Amoco) and of three large independent crude oil producers (Davis, Superior and True) presented testimony before the Commission. These nine companies paid 26 percent of the minerals royalties collected by the Federal Government last year.

The Commission held its five hearings in Washington, D.C., New York City, and Denver, Colorado. Each hearing was accompanied by a business meeting. All our hearings and business meetings were open to the public, so that everyone who had an interest was able to follow the progress of our deliberations and our recommendations. Moreover, after our first four months of work, we sent our draft recommendations to key representatives of the various interested parties with a request for comments at our fifth and final hearing. Representatives of states, Indian tribes, industry and Federal agencies offered comments. Many of the comments were helpful to us in putting our 60 detailed recommendations into final form.

The five Commissioners unanimously adopted each of the 60 recommendations.

FUNDAMENTAL CONCLUSIONS

Underlying the Commission's detailed recommendations are some fundamental conclusions we reached in the course of our inquiry:

The Government's royalty management system must have qualified managers. The scientifically oriented Geological Survey, which had managed royalties, had never been able to supply the active, sophisticated management that was needed. It was largely for this reason that the Commission recommended removing the royalty management function from the Geological Survey. In a separate office with a clearly defined mission, royalty management can attract managers with the training and experience required.

The Federal Government should work more closely with states and Indian tribes. In fulfilling its royalty management responsibilities, the Federal Government should cooperate much more than it has in the past with Indian tribes and states, sharing both information and specific tasks, such as auditing and site inspection.

On this point, the Commission was impressed with the willingness of Indian tribes and states to form a partnership with the Federal Government in effective royalty management. There are many talents and resources in the Indian tribes and states ready to be employed in such a joint endeavor. Together, we can accomplish a great deal more than the Federal Government has ever done in the past, or can do alone in the future.

The oil and gas industry should carry out its obligation, as lessee, to pay royalties in full and on time. The industry, not the Government, has primary responsibility for the detailed recordkeeping needed to assure that all royalties are paid. The industry also has the obligation to assure the security of lease sites. The industry, not the Government, is best suited to develop effective site security plans, subject to the Government's minimum standards.

The Federal Government should perform an oversight role. It must not waste its limited resources on tasks that are industry's responsibility. In managing royalty collection, it should not remain mired in bookkeeping details that rightly belong to the lessee. Instead, it should develop systematic, independent cross checks of royalties paid and reports submitted by companies, and it should impose meaningful penalties for false statements or gross errors. In helping to prevent theft, the Government should not issue detailed, rigid regulations for security of lease sites. Rather, it should monitor the companies' performance in carrying out their own site security plans and should penalize violations.

INTERNAL CONTROLS

Of the Commission's 60 detailed recommendations, more than one-third are directed toward creating an effective system of internal controls for royalty management.

Well-run organizations use a system of checks and balances, or internal controls, to protect their assets. These checks and balances give reasonable assurance to management that no misstatement of accounts either accidental or deliberate, is occurring.

Internal controls for the Federal royalty management system should assure that royalty payments are made in full and on time. At a minimum, they should meet the following four basic requirements:

1. Notice of new production: Federal royalty managers must have a record of new production as soon as it begins;
2. Records of amounts due and from whom: The royalty records must show accurately what

royalties have been paid, any royalties due, and who is responsible for payment;

3. Verification: Federal royalty managers must have enough information to verify company statements on the amounts of oil and gas produced, the amounts sold, and their value;

4. Penalties: The system must provide adequate penalties to undergird requirements for accurate and timely reporting.

The present royalty management system is so inadequate that it meets none of these minimum internal control requirements.

The new royalty management system as planned by the USGS meets only one of the requirements. The system is being designed to show what royalties have been paid, what are due, and who owes. Whether it will include enough information for verification of company reports on production is uncertain, since that part of the system is not designed yet. It clearly does not provide adequate penalties for underpayment, nor does it offer any system for notifying Federal royalty managers when new production starts.

The Commission's recommendations cover all of these minimum requirements. All are needed for effective royalty management.

Knowing When Production Starts

Today, the USGS has no systematic way of finding out when new production on a lease has begun. If a USGS district engineer wants to keep track of new wells on a current basis, he must resort to a weekly industry publication, Petroleum Information, which reports new wells but does not identify them by lease. The operator's monthly production report, which shows production on the lease well by well, may arrive six weeks to two months after an individual well actually starts to produce.

The startup date of production is a key fact in royalty management. In the first days of production, output is often exceptionally high -- "flush production," as it is termed by the industry. If a careless or dishonest operator fails to report the first days of production, royalty losses to the Federal Government could amount to thousands of dollars. Field inspectors in particular need to have prompt reports when new wells start to produce.

The Commission recommended that operators must notify the Department by telegram or equivalent means on the first business day after new production begins on a lease.

Keeping Track of Payors

The USGS cannot tell from its records which companies or individuals owe royalties, and even loses track of the identity of those who should pay. Ownership of oil and gas leases is commonly divided into a great many shares, or interests. Often, when an interest changes hands, the USGS never finds out about it. If the new interest owner does not pay up voluntarily, the royalty on that share may never be paid. Auditors in the state of Wyoming who are investigating a few selected Federal leases in their state, in cooperation with USGS, have so far actually collected $1.3 million in delinquent royalties. The project is a new one, and the auditors have not yet tallied all the causes for delinquency, but they have found that "lost payors" are an important cause.

For its new computerized system, USGS plans to establish a separate account for every fractionalized interest on all of its 18,762 leases; there may be as many as 650,000 accounts. To establish the new accounts, USGS also plans to track down all the payors who are currently missing.

The Commission believes that USGS has taken over a mammoth recordkeeping responsibility that rightly belongs to the lessees (that is, the industry). The Commission is doubtful that Federal royalty managers can on their own find all the missing payors in time for the startup date for the new system (which is next January). We also believe that keeping up with several hundred thousand payor accounts and the many continuing changes in ownership is a heavy and unnecessary burden for Federal royalty managers.

We are convinced that the industry should assume this job. The function belongs to industry, for lessees agree to pay the proper royalties when they sign the lease agreement.

The Commission recommended that a number of cross checks on company reports be built into the royalty management system. Where possible, the checks should be computerized and automatic -- for instance, comparison of company production data with sales and royalty data. Also, the Department should seek legal authority to require that purchasers of oil and gas produced from Federal and Indian leases send monthly statements to the Federal royalty managers. These statements could then be compared with the operators' reports.

The Commission noted that reports from inspectors in the field are a resource that is almost completely neglected in the present system.

Determining the Value of Production

Often, underpayments of royalties result from differing interpretation of the rules -- especially the rules for determining fair market value of the oil and gas produced from Federal and Indian lands. For the most part, the USGS has allowed the companies to determine the value for royalty purposes of the oil and gas. In a few cases, subsequent Government audits found that the values set by the companies were lower than USGS regulations allow. Typically, in these cases, a vertically integrated company produced natural gas on a Federal lease, used the gas in its own refinery, and valued the gas at lower long-term contract prices rather than at the higher current market prices.

The Commission recommended that Federal royalty managers require the lessee or his agent to submit a payor plan, signed by all payors, indicating the payment responsibility of each. The payor plan would have to be kept up to date.

The Commission also recommended, for the future, that the Department work toward designating an operator-of-record for each lease, who would be responsible for keeping all records related to royalty payments in that lease.

Verifying Production

Verification of the production reports submitted by companies is essential. Companies have made serious mistakes in their reports.

Field inspectors' observations of production, and sales documents (meter readings, run tickets, reports of oil measurements in sales tanks) are vitally important independent sources of information for cross checking company reports. Monthly statements compiled by purchasers of oil and gas are another important source of independent data.

Moreover, cross checks of two sets of company-furnished data -- those for production and those for sales -- can flag irregularities. Because two quite separate branches of an oil or gas company often prepare these two reports, entries in one may not necessarily match those in the other.

In some of the cases, the additional royalties assessed were very substantial.

It should be noted that in at least one instance of disputed valuation, industry officials told the Commission they had asked for, and failed to get, consistent guidance from the Government.

Establishing firm consistent rules for the valuation of natural gas is especially important. In the few audits to date, that is where the major deficiencies have been. Today, about one-half of Federal and Indian royalties are for natural gas. By 1990, it is estimated that natural gas will contribute 75 percent of the total minerals royalties.

The Commission recommended that by July 1, 1983, Federal royalty managers issue detailed guidance to the industry on valuing oil and gas from Federal and Indian leases.

Audits and Lease Reviews

To discover whether there are still large royalty payments outstanding from the past, the Department is planning to conduct over the next few years lease reviews and "look-back" audits of the larger royalty payors. The Commission was particularly concerned that critical reviews of past royalty payments be undertaken as promptly as possible. Most of our recommendations are directed at improving royalty management in the future. For redressing the failures of the past, look-back audits and lease reviews are essential. States and Indian tribes who receive royalties collected by the Federal Government have been actively concerned about cleaning up past accounts.

For the future, audits must not only be more frequent than they are now, but also must be planned, systematic, and integrated into a well-functioning system of internal controls. Results from past audits should be designed into the system, and provision should be made for audits triggered by irregularities -- for example, by computer flags of discrepancies between production and sales reports.

Finally, no system of internal controls will be effective unless it includes adequate penalties.

SITE SECURITY

The Commission gave careful consideration to physical security of lease sites. We concluded that oil thefts are occurring from Federal and Indian leases, and that they deserve serious national attention. There is no doubt that security is totally inadequate on many lease sites.

A number of witnesses with first-hand experience in the field described to the Commission widespread lapses of security and dubious practices which suggest that oil theft is occurring: storage tanks were left unlocked, valves were not sealed, seals were tampered with, large amounts of oil suddenly appeared in waste pits and just as rapidly vanished, and many unauthorized trucks were being seen in the field.

The opportunities for theft are there. The motives are strong with oil at $30 per barrel. Disposition of stolen oil is quite easy.

To improve the security of lease sites we recommend a system in which companies would develop their own site security plans, subject to minimum Government standards.

Our recommendation clearly puts the responsibility for preventing theft where it belongs, on the lessees. At the same time, our proposal is practical and flexible. The lessees know the sites, and have agents on many of them. Our recommendation gives the industry the flexibility to solve their specific security problems, while the Government meets its responsibilities by monitoring the industry's performance.

The Commission also recommended several measures that will make it more difficult for thieves to steal oil and to sell it. We recommend that:

- Truck haulers transporting oil from Federal and Indian leases be required to carry run tickets showing rightful possession of the oil;
- Federal inspectors be given the power to stop truck haulers and check for run tickets; and
- Purchase of crude oil without a document showing its origin be prohibited by Federal law.

ENFORCEMENT

The Commission emphasized throughout its report the vital importance of firm, consistent enforcement of the rules. At present, inspections are totally inadequate and penalties for violations are not meaningful. We recommend much more frequent inspections, both to check site security and to verify companies' production reports, and tougher penalties.

Inspection

Today, there are 63 USGS inspectors for over 17,500 Federal onshore and Indian leases. These inspectors are responsible for environmental, safety and many other tasks besides those related to royalty management (site security and production verification). In fact, the USGS estimates that field inspectors spend no more than 20 percent of their time on these two functions. The Department plans to hire 37 more inspectors for onshore leases, for a total of 100. But even with this augmented force, only 20 staff years would be devoted to checking site security and verifying production on the 17,500 onshore leases.

The Commission recommended in addition that the royalty management office have its own separate, specially trained inspection force.

Penalties

Sanctions for violation of site security rules or for persistent, serious underpayment of royalties are almost nonexistent.

The penalties that are imposed (mostly for failure to file reports) are highly inconsistent.

Damages that can be assessed at present are low -- $50 a day per violation on Federal leases and $500 a day on Indian leases. The Commission recommended new legal authority to assess civil penalties of up to $10,000 a day, depending on the seriousness of the offense.

Of course, the rules for levying penalties must be established fairly and openly, with opportunity for the industry to participate. Once the rules are established, application of penalties must be firm and consistent.

COOPERATION WITH STATES AND INDIAN TRIBES

Both the Indian tribes and states who share in royalties collected by the Federal Government are showing an unprecedented interest in the workings of the system. They are critical of past royalty management by the U.S. Geological Survey, but also recognize that their own involvement has been minimal in the past. Now, many have expressed eagerness to cooperate actively with the Federal Government in improving the royalty management program.

The Federal Government has a legally defined responsibility, as trustee, for proper management of Indian resources. However, concern about underpayment of royalties and oil theft has risen enough that several tribes in addition to the Shoshone and Arapahoe, have hired their own investigators, lawyers, and auditors to protect what they consider to be their rightful claims.

Several are also developing abilities in site inspection and financial management. The opportunities are great for closer cooperation between Federal royalty managers and the tribes. If given adequate training and resources, tribal inspectors could, I believe, do as good or better job than Federal inspectors, both because they are physically close to the lease sites, and because they have a strong personal stake in the full collection of royalties.

As a matter of fact, the Bureau of Indian Affairs and the Osage Tribe together collect Osage oil and gas royalties, and have done so since 1906 under a special law. The BIA agency office is located on the Osage Reservation, and is staffed in part by members of the Tribe. The connections are close. The BIA and Osage have worked out some excellent methods for keeping track of production quite beyond anything done so far by the USGS, which is responsible for collecting royalties on other Indian leases as well as on all Federal leases.

For example, the BIA and Osage have a computerized historical record of production from every lease. If production varies 11 percent either way from what is expected, an inspector goes out on the lease to find out why. Inspectors also spot check the amount of oil removed from storage tanks, to compare with sales reported by companies. In addition, to deter theft, the BIA and Osage require special markings on all of the oil trucks entering the Reservation.

The states, too, are anxious about Federal royalty management. Indeed, California had brought suit -- now deferred -- against the Federal Government, demanding an accounting of royalties back to 1920, and the establishment of a more reliable royalty management system. Other states -- Colorado, Arizona, Utah, New Mexico, Idaho, North Dakota, Montana, Nevada, and Washington -- joined California as friends of the court. But the states, like the tribes, have shown great interest in cooperation with the Federal Government.

Wyoming has already taken part in a cooperative program of reviewing Federal leases within the state and has identified millions of dollars of deficiencies in the first few months of operation. Other states are now taking part in similar programs.

The Commission recommended that the Secretary of the Interior announce an expanded policy of cooperation with states and Indian tribes. The program should include cooperative agreements, especially for audits, inspection of leases, and training. The Department should enhance the two-way flow of information between Federal royalty managers and states and Indian tribes, using common data elements for industry reporting, insofar as possible; sharing information on results of audits and site inspections; and making sure that states and Indian tribes have the information they need, on a timely basis, to check the accuracy of their royalty payments.

The Commission also recommended the creation of a self-sustaining fund to pay for extra audits and inspections, beyond those included in the regular budget. The fund would be supported by a small levy (one-half of one percent) on all Federal royalty collections. The percentage could be varied from zero to one percent, at the decision of the Secretary, depending upon needs and disbursements from the fund.

ORGANIZATIONAL CHANGES

After most extensive deliberations, the Commission concluded that royalty management should be moved out of the USGS and into a high level independent royalty management office within the Interior Department. This was one of the first recommendations implemented by the Secretary. We believe that the Geological Survey's primary scientific and technical mission is inherently inconsistent with the mission of effective royalty management. Scientists and engineers, who are the top managers of the Survey, usually do not make the best royalty managers. USGS royalty management has been a much-criticized failure for more than 20 years. We believe that administration of royalty management would remain inadequate in an agency which is scientific and technical in origin and outlook.

NEW APPROACHES TO ROYALTY MANAGEMENT

The Commission concluded there is no time to waste in improving royalty management. We recommended that the Federal royalty managers proceed as swiftly as possible toward completing and adopting the new, fully computerized royalty collection system. Elements of this complex system should be pretested, on a manual basis if necessary, to establish that they are feasible before full automation is completed. Moreover, we recommended that the Commission's proposals, as adopted by the Secretary, be fully integrated into the new system.

We also emphasized that most of our recommendations can be implemented now, without waiting for completion of the new royalty management system that the USGS is developing. It will be two years at a minimum before all phases of the new system are ready for adoption. Nor should the necessary changes wait until reorganization of the royalty management function is complete. Royalty management can and should be greatly improved starting today.

The Commission recommended that the basic royalty rate for Federal onshore leases and Indian leases be raised from one-eighth (12-1/2 percent) to one-sixth (16-2/3 percent). The rate for offshore leases, for many private leases, and for some Indian leases is already at least one-sixth. The Commission saw no reason for the disparity.

Finally, the Commission was concerned about sustaining interest in and attention to royalty management long enough to assure that constructive, lasting improvements are built into the system. We recommended that the Secretary prepare an annual report on progress in improving royalty management and, specifically, in implementing the Commission's recommendations which are adopted by the Secretary. The report should be submitted to the states and Indian tribes for review, and incorporate their comments. It should be made available to appropriate committees of the Congress and to the public.

LEGISLATION NEEDED AND S. 2305

The Commission suggested that the most effective way to make the several legislative changes needed for effective royalty management is to design an omnibus royalty management improvement act. Our report suggested such a bill include:

TO IMPROVE INTERNAL CONTROLS IN ROYALTY COLLECTION

1. Require that purchasers of oil and gas from Federal and Indian leases submit monthly reports to Federal royalty managers

TO DETER THEFT

2. Require that truck haulers of oil from Federal and Indian leases carry run tickets

3. Empower Federal inspectors to stop trucks and check run tickets

4. Prohibit the purchase of undocumented oil, with criminal penalties for violation

TO ENFORCE LESSEE'S ROYALTY PAYMENT AND SITE SECURITY OBLIGATIONS

5. Authorize civil penalties for site security violations; for nonpayments, late payments and error-ridden reports; for failure to submit the required payor plan; for failure by purchasers to submit required reports

TO EXTEND COOPERATION WITH STATES AND INDIAN TRIBES

6. Authorize states and Indian tribes to carry out royalty management and site security functions under cooperative agreements with Federal royalty managers
7. Create a self-sustaining fund to finance supplemental audits, inspection, and training
8. Authorize the Federal Government to share with states interest and penalties paid for late payments and underpayments

TO REMOVE UNNECESSARY BURDENS FROM GOVERNMENT AND INDUSTRY

9. Amend the Outer Continental Shelf Lands Act to allow prompt refund of any overpayment of royalties on offshore leases
10. Relieve Federal royalty managers of the obligation to calculate and pay the Windfall Profit Tax

To a large extent, Bill S. 2305 includes these items. The one major variation appears in Section 20, Funding.

Section 20 provides, "...there shall be deducted from royalty collections an amount not to exceed one percent of royalties estimated to be collected by the United States.....A proportionate amount of the total royalty collected from each royalty source shall be deducted prior to any division and distribution of royalties to the States, Indian tribes, and individual Indian allottees, or the Treasury, and the sums so deducted shall be deposited in the Treasury as miscellaneous receipts......" It continues, "For purposes of this section, the following activities shall be considered royalty management activities: accounting, auditing, product valuation, data collection, regulation writing, enforcement, and engineering technical support."

This funding provision is a blanket assessment, the proceeds of which go directly to the Federal Treasury. On the other hand, the Commission recommended the establishment of a self-sustaining fund supported by a deduction from oil and gas royalty income to be used for "auditing and inspection," especially to be used for auditing and inspection cooperatively with the states and Indian tribes. Page 132 of our report states:

> It must be emphasized that the self-sustaining fund should not be used to pay for the basic, continuing royalty management program which is covered by the Federal budget. Nor should it be used as a device to avoid including a full complement of audits and inspections in the basic, continuing program. Rather, the fund must be devoted to the special augmented program of audits and inspections, much of it done under contract by States and Indians.

The variation in S. 2305 defeats the basic purpose for that recommendation.

The other provision in the bill which runs at variance to our recommendation is Section 5(a)(2), Duties of Interest Holders, Lessees, Operators, and Motor Vehicle Transporters. The relevent portion states that any interest holder of any lease shall ".... notify the Secretary, within such time and in such manner as the Secretary may specify, of any assignments he may have made of any interest in a lease, of his obligations and responsibilities for royalty payments under a lease, and of any recordkeeping or other obligation as may be imposed by the Secretary under the authorities granted by this Act or any other mineral leasing law."

As I pointed out earlier in my testimony, the Commission believes the function of keeping track of the several hundred thousand payors is a heavy and unnecessary burden for Federal royalty managers. The function belongs to industry, for lessees agree to pay the proper royalties when they sign the lease agreement. As we stated in our report on pages 50 and 51:

> The Commission believes that for this problem, as for many others involved in running an effective royalty management system, the approach should be to place primary responsibility on the industry, with advice and guidance from the managers of the Federal royalty program. Lessees, under terms of their leases, do have the contractual obligation to pay royalties. This obligation can be assigned by the lessee to others.
>
> Beginning immediately, the Department should require that lessees submit a payor plan identifying all payors and their interests for each lease and that the plan be continually kept up to date. It should be the responsibility of the lessee or his agent to notify the Department if any change is made in payor responsibility.

I would suggest Section 5(a)(2) state this requirement in unequivocal terms.

In spite of those two observations, I believe S. 2305 is a good bill, and I strongly urge its adoption. This legislation together with the constructive action already taken by Secretary Watt will assure that royalty management of our Nation's energy resources will be fair and effective.

Mr. Chairman, this concludes my prepared testimony. I shall be pleased to elaborate on any of the points I have made, or to respond to any questions. I appreciate the opportunity to discuss this matter with you.

Senator **Wallop**. Thank you, Mr. Linowes. Your Commission as I recall it recommended only civil penalties for purchasers for purchase of undocumented oil, and the bill recommends both civil and criminal.

Do you agree that it should be both?

Mr. **Linowes**. The bill does?

Senator **Wallop**. It recommends civil and criminal.

Mr. **Linowes**. Well, I understand in one place it says criminal, but otherwise it is quite vague, and I understand that is going to have to be tightened up on speaking to the drafters of the bill, but our recommended legislation clearly suggested criminal penalties for undocumented oil.

Senator **Wallop**. Would that be the same for site security?

Mr. **Linowes**. No. That would be too severe in most cases. There has to be that distinction, civil penalties there, but criminal penalties, if someone were to purchase stolen oil or any other stolen property, he would be subject to criminal penalties.

Senator **Wallop**. Interestingly enough, back in Wyoming at least, if you buy cattle without inspection, you are just as bad off as the guy who sold them. That translates reasonably similarly.

Mr. **Linowes**. Of course, it is our feeling that there should be no difference here. As a matter of fact, we have found installers, there is quite a business in installing oil. They dispose of it very readily, and if we were to try to tie up the refinement process, that is, what a refiner buys and what a pipeline company buys, we feel we can tie up considerably the opportunity for those that steal oil to dispose of it, although some crude oil can be used in places, especially on ships I understand, and some industries, but it would really close down their main outlet. I think that is very important.

Senator **Wallop**. Your Commission as well recommended that lease subaccounts be set up in which each payer for a lease has an account. It appears this might negate the request here that a lease operator be totally responsible.

Mr. **Linowes**. We would like to see the lease, the operator be totally responsible. We realize because you have so many leases—we would like to work through that. As a matter of fact, we spelled that out in our report. At the present time, however, it is not practical to implement that. I don't know if the lessor, and I say I did not investigate it, I am not sure that the leases as presently written even gives that authority for that requirement. Even if it does, I think the industry can make a strong case that based on tradition, we can't suddenly begin holding the operator fully responsible for everything, but that is just good, sound business practice. There is no reason why the person who signs that lease should not also maintain responsibility, but for the present, we have to plug that hole right now, and what we have to plug is the fact that in this day we don't know.

Now the Department is moving forward. The new system that is being designed has been computerized and anticipates that there will be individual payers identified and maintained by the Government which we feel is an unreasonable and unfair burden on the Government. Nevertheless, until we do find out what the—we do know there is some assessment, 650,000 of various fractionalized leaseholders, and it has been estimated by the Department that at best the most they can expect is to identify when the job is done about 85 percent of them; 15 percent will be lost because they are people that bought interest, never sent in any royalties at the outset, and therefore can't be identified.

Senator **Wallop**. What about the problem in section 12 about the two-tier price problem? Is that adequately addressed? It wasn't in your report.

Mr. **Linowes**. Yes. It wasn't. There are several items in this draft legislation that the Commission did not address itself to, that one, and there are several items in this bill that I was told on inquiry, especially those extensive ones dealing with penalties, were required for reasons beyond the scope of what the Commission was involved with.

Senator **Wallop**. You pointed out that there was no systematic way of finding out when new production on a lease began, and I mentioned it here today, took it out of your statement. I wonder if you could expand a little bit to the committee as to why you feel that first day notification is of consequence to States, tribes, or the Federal Government?

Mr. **Linowes**. Yes. We found, for one thing, very often your peak production is at the beginning. When you strike oil, you get tremendous production. We found based on testimony and research that how prevalent it is we didn't know because there was no way of determining that to any refined extent. The oil drillers would occasionally not report that they struck oil until a week later, a few days later. I think in one case it even dragged out for 3 months. Hundreds of thousands of dollars, even millions, could be lost during that period. There is no reason, and our recommendations point out that we think it should be mandatory that the operator be required to report the next business day. That is not an unreasonable request if he does it within business hours, that that oil is coming out of the well; as a matter of fact, one of the large deficiencies that Mr. Pendley referred to had to do—this is just recently identified—in which there is the question of late reporting not necessarily of new oil, but the shifting of ownership where there were no payments made whatsoever in this period, and there is close to $7 million of deficiencies.

This is something they just found. It is not uncommon.

Senator **Wallop**. But I have two problems with the concept. One is that the royalty isn't collected or indeed owed until it is sold, and it isn't sold off the site necessarily, I mean from the production instant. It is sold from when it arrives at a refiner, and I just wonder if it isn't, I wonder if that isn't a mountain/molehill kind of situation because I don't really see that. If the problem is collecting that at the point of sale, undocumented or documented, we have got that problem we hope resolved, but in my experience, it doesn't matter—if you are going to produce a well for 30 days, you still don't pay anything until ultimately a tank sits there. It is sold, so what difference does it make really to the Government or a tribe or a State to know exactly which day that started?

Mr. **Linowes**. Perhaps I should back up and explain the procedure that has been the practice for 20 years. A corporation or an operator must submit two reports each month. One is the production that comes out of the well, regardless of whether it is sold. Generally that is filed by one division of a company.

The other one is a sales report. Royalties are based on the sales report. Traditionally what the Geological Survey has been doing is taking those production reports, based on testimony, and throwing them into a cardboard box. That production report again is a very valuable internal control document.

Senator **Wallop**. It would be, but it doesn't then file the lease.

Mr. **Linowes**. I will explain why. If you match for a month the production reports and for the same month the sales reports on a continuing basis, they should relatively jive. A number of deficiencies have come to light because people like Charles Thomas and George Campbell sat down at their kitchen table and matched them, and in one case, there is $35,000 produced from a well, zero reported on the sales report. In another case it is something like 15,000, and when I questioned the executive of the company involved, he said yes, he knew about that case. That was just a mistake. I said that is $35,000. I said well, here are other items like that. He said that was one man who made those mistakes and we fired him.

Well, I would feel a little more comfortable if occasionally there is zero production and $35,000 worth of barrels were reported on sales that they paid royalties on that side. These are the things that were very disturbing to the Commission.

The production report is very important. It is true they don't pay royalties until that sales report is submitted. Therefore, it is no burden to require them to notify. They have to notify the Government some time. The Minerals Management Service is asking them to notify them in the proper normal course of business in the business day.

Senator **Wallop**. If the other provisions of the bill, though, were in place, it would seem that is not necessary. In other words, if you can't purchase undocumented oil, aren't we just putting in place yet another thing which says the same thing?

Mr. **Linowes**. No. The undocumented oil deals with a completely different aspect. These generally are people that steal. They have no right, no claim, no business being on the lease site very often. These delays in filing production coming from new wells or these inadequate reports, production reports, are people who legitimately are the lessees of those lease sites so that is in effect already in the stream of the refinery process and the pipeline process.

Senator **Wallop**. In your written statement you make reference to the funding provisions in section 20. Is it your opinion that the bill as it is drafted and lies before us would allow States and Indian tribes to be reimbursed for duties carried out under cooperative agreements?

Mr. **Linowes**. Well, I think that would be covered by one of the other sections clearly where we give the Secretary authority to work in section 18 the cooperative agreement with States and with the Indian tribes.

Section 20 strikes me as just across-the-board assessment, and I don't know that since these funds will go into the Treasury, that doesn't permit the Department to use that 1 percent any more than it can use what was normally budgeted and approved by Congress in its budget.

Senator **Wallop**. It probably ought to be maybe cross-referenced from section 20 back to 18(c) because it doesn't give the Treasury any authority to make that transfer.

Mr. **Linowes**. No. The Treasury just collects the money, and that's it, from the way this reads to me. As a matter of fact, it says, "The sum shall be deposited in the Treasury as miscellaneous receipts," and therefore it is out of the control of the Secretary. That goes directly, just like a tax is another way to look at it.

Senator **Wallop**. Well, assuming that the fund is clearly enough established that it has got authority to do what we want it to do, I think that is a problem.

Staff informs me that the fund reimburses the Minerals Management Service.

Mr. **Linowes**. Yes. Well, actually this does not provide for a separate fund the way I read section 20. It just is they dump it into the Federal Treasury.

Senator **Wallop**. That is correct, but that is not exactly what your Commission would do.

Mr. **Linowes**. No. That is completely different. That is the one big variation. I have no objection. I can see good, sound business reason for it. No doubt the States and Indian tribes would object because it really is skimming 1 percent off for something they would be getting for free, and I have the question whether they should be getting it for free all these years, but what we wanted was a pot of money.

Senator **Wallop**. It hasn't been free. He has been costing the hell out of the inefficient service.

Mr. **Linowes**. Excepting this money still won't be used to improve the auditing and inspection per se which is what we had in mind you see, and one of the reasons for it is this. The Department of the Interior and the Geological Survey in particular, its primary responsibility, to give some perspective to what I am saying, is to protect our natural resources, and the Geological Survey has done a great job of it, and what would happen when they get funded, there would be the bias toward the scientists and geologists, the engineers as opposed to what they might consider pencil pushers and bookkeepers which are really highly skilled accountants and financial administrators.

It is one discipline respecting their own rather than recognizing the need for that kind of a function you see, and we want to make that break with this kind of a fund as well as ask the States and Indian tribes to participate.

Senator **Wallop**. Thank you very much for your testimony here. Would it be agreeable to you to ask a couple of rather more specific questions that staff has relating to your report and recommendations as they are implemented by the bill? We would like to have a couple of responses from you as to your opinion.

Mr. **Linowes**. I would be very pleased to, Mr. Chairman. Further I should add the Secretary and the Undersecretary and others within the Department have been in touch with me on a rather frequent basis. I have been trying to be of assistance. I have met with the Minerals Management Group, and as a matter of fact to this day I am trying to assist in identifying the director for the Minerals Management Service because we think it is especially critical that this be moved as quickly as possible.

Senator **Wallop**. Thank you very much. The next witness is Mr. Wilbur Campbell, Acting Director of the Accounting and Financial Management Division for the General Accounting Office.

Good morning, Mr. Campbell.

Mr. **Campbell**. Good morning, Mr. Chairman. I would like to introduce my colleagues this morning, Mr. Ruprecht on my right from our Office of General Counsel, and Mr. Darby Smith on my left who has been involved on the oil side in our financial problems for a long time.

STATEMENT OF WILBUR D. CAMPBELL, ACTING DIRECTOR, ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION, GENERAL ACCOUNTING OFFICE, ACCOMPANIED BY RICHARD RUPRECHT, OFFICE OF GENERAL COUNSEL, GENERAL ACCOUNTING OFFICE; AND DARBY SMITH, GENERAL ACCOUNTING OFFICE

Mr. **Campbell**. We submitted for the record my testimony. In the interest of time, we will highlight some of the issues.

We are here at your request to testify on S. 2305, a bill to improve the accounting and control for revenues due from Federal and Indian lands.

We support the legislation and would like to discuss the major provisions of the bill which if enacted should improve on the royalty accountability.

S. 2305 would require the Secretary of the Interior to be notified when any new well on a lease begins production. Also the bill would require that the lease holder notify the Secretary of any lease assignments or changes in responsibility for royalty payments and/or recordkeeping. We support these provisions.

Currently Interior has no systematic way of knowing when new production begins on a lease. Requiring in law that the Government be notified when new production being should go a long way to remedy this problem. To augment this notification requirement, we have previously recommended that Interior increase its use of lease inspections to determine when new wells start production.

Further, the bill's requirement that the Secretary be notified of lease assignments and changes in responsibilities for royalty payments and recordkeeping would provide the Department the information needed to maintain exact accountability of leases and payers from whom royalties are due.

The proposed legislation requires that each lessee develop a site security plan in conformance with the standards to be established by the Secretary of the Interior. We support this proposal. Site security for Federal and Indian lands has been extremely lax. The Department of the Interior must take the lead in establishing minimal requirements in designing an inspection strategy. The strategy must be interfaced with the accounting as well as the industry to affect improved security.

An important element of site security is the lease inspection function. We have long called for the development of an inspection plan and for field inspectors to assist accounting by determining the reasonableness of inventory and sales data shown on the production reports and reporting on those discrepancies.

S. 2305 would also require that anyone transporting mineral resources from a Federal or Indian lease must maintain documentation showing from whom such resources were obtained. We support this proposal as well. Currently such documentation is not required. We have previously called for the use of run tickets as a means to verify the amount of reported production. We have recommended that Interior determine what use the production phase of the new royalty accounting system, now targeted for implementation in fiscal 1984, will make of run tickets as well as other sources to verify production.

S. 2305 stipulates that civil fines and penalties up to $10,000 a day can be assessed for failure to comply with the provisions of the bill. However, the bill as presently written does not provide for the assessment of these fines and penalties for the violation of lease provisions or any rules and regulations that may be issued pursuant to the bill. We suggest that the proposed legislation be amended to provide this consideration.

We note the Secretary is currently authorized by the Outer Continental Shelf Lands Act of 1954 to assess fines and penalties in such instances for offshore leases. If amended as we suggest, S. 2305 would provide the Secretary similar authority for onshore leases.

S. 2305 stipulates that all individuals associated with the lease must maintain and provide records as specified by the Interior Secretary. We support this requirement. Presently Interior does not have any express statutory authority giving it access to records of the lessee, lease interest holder, those engaged in developing the lease, and those transporting the mineral resources from the lease. The standard lease agreement grants the Department broad rights of access to all relevant books, accounts and records regarding the leased lands, including production records, but this authority does not go beyond the lessee.

Enactment of S. 2305 would provide the Secretary the needed access authority, thereby strengthening accountability. The proposed legislation would allow the Interior Secretary to refund or credit any overpayment made to the Government for an offshore lease without congressional approval once the Secretary is satisfied that more has been paid than was required.

We support this change. If enacted, refunds for onshore and offshore lease would be granted in the same manner. Under the current provisions of the Outer Continental Shelf Lands Act, a refund cannot be granted without notification of the Congress. Preparing these requests are very time consuming and of questionable benefit. Change in the offshore refund policy would improve the Department's ability to monitor and audit the lease account records.

S. 2305 provides for charging interest on all late royalty payments in accordance with Treasury regulations. This is in line with comprehensive debt collection legislation introduced in the Senate Debt Collection Act of 1981 and under consideration in various accompanying House bills which GAO also supports.

The need to insure timely payment of royalties has been recognized by Interior which plans as part of its new royalty accounting system to use the computer to identify and assess late payment charges.

S. 2305 would provide that all interest charges be distributed to the Government and the States in accordance with 30 U.S.C. 191. Presently the States do not share in the interest collected on late royalty payments. The Government and the States share royalty collections on Federal lands at a rate established by law. Sharing of interest charges would be consistent with this policy. The proposed legislation, however, does not mention the sharing of interest charges with the Indians. We believe that consideration should be given to adding such a provision.

Since the Government is collecting for the Indians as trustee and has no claim on the royalties, it would follow that any interest earned on such royalties would go to the trust beneficiary—the Indians.

Also the bill provides that the funds would be distributed to the States as often as is administratively convenient, but at least on March 31 and September 30. Whether to pay States their share of royalties more rapidly is a policy matter. The Commission on Fiscal Accountability indicated that more rapid payment could be used as a financial incentive for shifting some of the royalty management work to the States. There is potentially tens of millions of dollars in interest involved. We suggest that the proposal be coordinated with the Department of the Treasury and the costs and benefits carefully studied.

S. 2305 provides for the Secretary to enter into cooperative agreements with the States and Indian tribes to share in the royalty management functions. We support this provision as well. In testimony before the Commission on Fiscal Accountability, various States and Indian tribes expressed a desire to be more active in royalty management, both in site security and royalty collection.

Recently, Interior entered into a cooperative audit agreement with several States and plans agreements with others. The Commission recommended that this effort be expanded to include Indian tribes and the inspection function.

S. 2305 provides for the establishment of a self-sustaining fund for the operation of the royalty management function. An amount not to exceed 1 percent of the royalties collected after payment of the applicable windfall profits tax and prior to any distribution to the States, Indians, or the Federal Government, would be set aside for royalty management.

Though the proposal provides for a sharing of the costs with the States and Indians, most of these costs would still fall on the Federal Government. About 75 percent of the royalty collections relate to offshore production for which the States and Indians do not receive a share of royalty income. At the same time, most of the royalty management problems requiring attention are related to onshore production.

In addition, it is unfair to us if the fund would cover the cost incurred by the Inspector General in the audit of oil and gas companies, and the planned contract audit of the top 25 oil and gas companies that pay royalties to the Federal Government. We are not certain whether these funds can be used for the costs incurred in the development and implementation of the new royalty accounting system and for lease inspections.

Further, we are unclear as to whether the funds can be used to pay for costs incurred in any hearing or investigation conducted by the Interior Secretary under section 6 of S. 2305. We suggest these matters be clarified prior to enactment of the legislation.

We are also concerned that the proposed legislation may encumber the authority that the Interior Secretary already has under 25 U.S.C. 413 to collect reasonable fees to cover the cost of any work performed with the Indians. The committee may wish to amend section 20 of S. 2305 to provide that the Secretary's authority under 25 U.S.C. 413 is not affected by the enactment of the proposed legislation.

This concludes my statement, Mr. Chairman. We will be happy to respond to any questions you may have.

[The prepared statement of Mr. Campbell follows:]

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

FOR RELEASE ON DELIVERY
EXPECTED AT 9:30 AM EST
May 3, 1982

STATEMENT OF
WILBUR D. CAMPBELL
ACTING DIRECTOR
ACCOUNTING AND FINANCIAL MANAGEMENT DIVISION
BEFORE THE
CHAIRMAN, SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES
ON
THE FEDERAL ENERGY AND MINERAL RESOURCES ACT OF 1982

Mr. Chairman and Members of the Committee:

We are here at your request to testify on S. 2305, a bill to improve the accounting and control for revenues due from Federal and Indian lands. The proposed legislation is in response to the recommendations made in a January 1982 report by the Commission on Fiscal Accountability of the Nation's Energy Resources--an independent Commission established by the Secretary of Interior to develop solutions to the minerals management problems that have continually plagued royalty accounting. We worked closely with the Commission and testified in support of their report on March 23, 1982, before the Subcommittee on Interior, House Committee on Appropriations.

Historically, high priority has not been placed on the collection of oil and gas royalties. Serious deficiencies in the collection system that we identified over 20 years ago still persist today, with large sums going uncollected each year. In addition, significant amounts of royalty income have not been collected when due, thus increasing the Government's costs of borrowing.

The proposed legislation, combined with the Department of Interior's ongoing effort to design a new royalty accounting system and implementation of the recommendations in our prior reports as well as the Commission's report should provide the foundation for resolving the longstanding financial management problems. We support the legislation and I would like to discuss the major provisions of the bill, which if enacted, should improve royalty accountability.

NOTIFYING THE SECRETARY OF INTERIOR OF CHANGES IN LEASE STATUS

S. 2305 would require that the Secretary of Interior be notified when any new well on a lease begins production. Also, the bill would require that the lease holder notify the Secretary of any lease assignments, or changes in responsibilities for royalty payments and/or recordkeeping. We support these provisions.

Currently, Interior has no systematic way of knowing when new production begins on a lease. Further, the new royalty accounting system now being designed will not provide this information. Therefore, if an operator does not report production when it begins, royalty losses to the Federal Government, Indian tribes and the States could be substantial.

Requiring in law that the Government be notified when new production begins should go a long way to remedy this problem. To augment this notification requirement, we have previously recommended that Interior increase its use of lease inspections to determine when new wells start production.

Further, the bill's requirement that the Secretary be notified of lease assignments and changes in responsibilities for royalty payment and recordkeeping would provide the Department the information needed to maintain exact accountability of leases and payors from whom royalties are due. In our October 1981 report titled "Oil and Gas Royalty Collections--Longstanding Problems Costing Millions" (AFMD-82-6, Oct. 29, 1981), we pointed out that from time to time Interior has received royalty checks for which it is unable to identify the leases involved. This problem could be corrected through enactment of the proposed legislation.

IMPROVEMENTS NEEDED IN SITE SECURITY

The proposed legislation requires that each lessee develop a site security plan in conformance with the standards to be established by the Secretary of Interior. We support this proposal.

Site security for Federal and Indian lands has been extremely lax. The Department of Interior must take the lead in establishing minimal requirements, in designing an inspection strategy--a strategy that must be interfaced with accounting, as well as the industry to affect improved security.

An important element of site security is the lease inspection function. We have long called for the development of an inspection plan, and for field inspectors to assist accounting by determining the reasonableness of inventory and sales data shown on production reports and reporting on discrepancies. Interior agreed and issued instructions requiring communication and assistance between field inspectors and accountants when inconsistent or questionable data are reported. However, even though the Department reported 28,283 field inspections during fiscal 1980, we found no indication that field inspectors and accountants have worked together to verify production data. Interior officials confirmed that this is rarely done and told us that accountants continue to accept the company reports as accurate.

Questions have also been raised about the quality of the lease inspections. The Interior Department's field inspecting and monitoring were severely criticized at hearings before the Senate Select Committee on Indian Affairs; the Subcommittees on Oversight and Investigations and Mines and Mining, House Committee on Interior and Insular Affairs; the Commission on Fiscal Accountability; and this Committee. It was pointed out that because of inadequate lease inspecting and monitoring, thefts and violations on Federal and Indian lands have gone undetected. The Department had only 60 inspectors to review activities at over 44,000 producing wells. This is not enough inspectors to provide adequate coverage. Violations are apt to occur and go undetected. Interior has indicated it will devote additional resources to the Inspection effort.

S. 2305 would also require that anyone transporting mineral resources from a Federal or Indian lease must maintain documentation showing from whom such resources were obtained. We support this proposal. Currently, such documentation is not required. We have previously called for the use of runtickets as a means to verify the amount of reported production. We have recommended that Interior determine what use the production phase of the new royalty accounting system, now targeted for implementation in fiscal 1984, will make of runtickets as well as other sources to verify production.

The production phase is extremely important because of the need to alleviate the reliance on information reported by the oil and gas companies. The matching of production and sales data, which will be facilitated by the proposed bill's requirement to use runtickets, will enable the Department to identify situations where oil and gas produced was not properly accounted for. It would also provide the means to monitor lease activities and identify irregularities in reported production and/or sales, and can be used as an indication of the reasonableness of the reported data.

STRENGTHENING SANCTIONS FOR VIOLATIONS

S. 2309 stipulates that civil fines and penalties--up to $10,000 a day--can be assessed for failure to comply with the provisions of the bill. However, the bill as presently written does not provide for the assessment of these fines and penalties for the violation of lease provisions or any rules and regulations that may be issued pursuant to the bill. We suggest that the proposed legislation be amended to provide this. We note that the Secretary is currently authorized by the Outer Continental Shelf Lands Act of 1953 as amended (43 U.S.C. 1350) to assess fines and pentalties in such instances for offshore leases. If amended, as we suggest, S. 2305 would provide the Secretary similar authority for onshore leases.

Sanctions for lease violations or for persistent serious underpayment of royalties are presently almost nonexistent. Further, those that are imposed, mostly for failure to file reports, are not imposed consistently. We have not examined in any detail the issue of sanctions for violations. However, there is no doubt that companies must have an incentive to comply with program requirements. More importantly, the Government must enforce its authority. Lease cancellations, for example, have not been pursued in cases of repeated violations. The use of sanctions is therefore a logical and practical means of ensuring programs regulations are adhered to.

RECORDKEEPING REQUIREMENTS EXPANDED

S. 2305 stipulates that all individuals associated with the lease must maintain and provide records as specified by the Interior Secretary. We support this requirement.

Presently, Interior does not have any express statutory authority giving it access to records of the lessee, lease interest holder, those engaged in developing the lease, and those transporting the mineral resources from the lease. The standard lease agreement grants the Department broad rights of access to all relevent books, accounts and records regarding the leased lands, including production records, but this authority does not go beyond the lessee. Enactment of S. 2305 would provide the Secretary the needed access authority, thereby strengthening accountability.

PROCEDURES FOR MAKING OFFSHORE REFUNDS REVISED

The proposed legislation would allow the Interior Secretary to refund or credit any overpayment made to the Government for an offshore lease without congressional approval once the Secretary is satisfied that more has been paid than was required. We support this change.

If enacted, refunds for onshore and offshore lease would be granted in the same manner. Under the current provisions of the Outer Continental Shelf Lands Act, a refund cannot be granted without notification of the Congress. The refund cannot be made until the Senate and the House has had 30 days of continuous session--which is normally more than 30 calendar days--to consider the request.

Preparing these requests are very time consuming and of questionable benefit. As discussed in our October 1981 report, in Interior's Metairie office--where most offshore leases are located--about 60 percent of the audit staffs' time is spent processing offshore refund requests. In fiscal 1980, 43 refund requests were received, while in the first 5 months of fiscal 1981, 36 requests were received. Changing the offshore refund policy would improve the Department's ability to monitor and audit the lease account records.

CHARGING INTEREST ON LATE ROYALTY PAYMENTS

S.2305 provides for charging interest on all late royalty payments in accordance with Treasury regulations. This is in line with comprehensive debt collection legislation introduced in the Senate "The Debt Collection Act of 1981" (S-1249) and under consideration in various accompanying House bills which GAO supports. S.1249 calls for interest to be assessed at rates set by the Treasury quarterly. The legislation also provides for charges to cover additional costs of processing and handling delinquent claims, and a penalty charge, not to exceed 6 percent per annum, for failure to pay any debt more than 90 days past due.

The need to insure timely payment of royalties has been recognized by Interior which plans as part of its new royalty accounting system to use the computer to identify and assess late payment charges. If properly implemented, this should satisfy our longstanding recommendation calling for the computer identification of late payments.

INTEREST CHARGES TO BE SHARED

S.2305 would provide that all interest charges be distributed to the Government and the States in accordance with 30 U.S.C. 191. Presently the States do not share in the interest collected on late royalty payments.

The Government and the States share royalty collections on Federal lands at a rate established by law. Sharing of interest charges would be consistent with this policy. The proposed legislation, however, does not mention the sharing of interest charges with the Indians. We believe that consideration should be given to adding such a provision. Since the Government is collecting for the Indians as trustee and has no claim on the royalties, it would follow that any interest earned on such royalties would go to the trust beneficiary--the Indians.

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Also, the bill provides that the funds would be distributed to the States as often an administratively convenient but at least on March 31 and September 30. Whether to pay States their share of royalties more rapidly is a policy matter. The Commission on Fiscal Accountability indicated that more rapid payment could be used as a financial incentive for shifting some of the royalty management work to the States. There is potentially tens of millions of dollars in interest involved. We suggest that the proposal be coordinated with the Department of Treasury and the costs and benefits carefully studied.

INCREASED COOPERATION WITH THE STATES AND INDIAN TRIBES

S.2305 provides for the Secretary to enter into cooperative agreements with the States and Indian tribes to share the royalty management functions. We support this provision.

The States and Indian tribes have a definite interest in the collection of oil and gas royalties. The States receive 50 percent of the royalty income for oil and gas removed from Federal land within their borders, and the Indian tribes and individual Indian landowners receive all of the royalties collected on minerals removed from their lands.

In testimony before the Commission on Fiscal Accountability, various States and Indian tribes expressed a desire to be more active in royalty management--both in site security and royalty collection. Recently, Interior entered into cooperative audit agreement with several States and plans agreements with others. The Commission recommended that this effort be expanded to include Indian tribes and the inspection function.

To alleviate reliance on unverified data, we have long called for the Department to determine what secondary sources of data are available among Government and State agencies and in the oil and gas industry. We have recommended that Interior explore the possibility of sharing its auditing and inspection responsibility, and of exchanging information on production and sales with the States.

ESTABLISHMENT OF SELF-SUSTAINING FUND

S.2305 provides for the establishment of a self-sustaining fund for the operation of the royalty management function. An amount not to exceed one percent of the royalties collected, after payment of the applicable windfall profit tax and prior to any distribution to the States, Indians or the Federal Government would be set aside for royalty management.

In today's environment of budget constraints and reductions, funding of the royalty management program is an important consideration. Improving royalty accounting is not a short-term proposition. A significant investment will be required in terms of new systems and additional personnel. Gains, however, should easily offset costs. This alternative is one way of funding the additional effort.

Though the proposal provides for a sharing of the costs with the States and Indians, most of these costs will still fall on the Federal Government. About 75 percent of the royalty collections relate to offshore production for which the States and Indians do not receive a share of royalty income. At the same time, most of the royalty management problems requiring attention are related to onshore production.

In addition, it is unclear to us if the fund would cover the cost incurred by the Inspector General in the audit of oil and gas companies and the planned contract audit of the top 25 oil and gas companies that pay royalties to the Federal Government. Also, we are not certain whether these funds can be used for the cost incurred in the development and implementation of the new royalty accounting system and for lease inspections. Further, we are unclear as to whether the fund can be used to pay for costs incurred in any hearing or investigation conducted by the Interior Secretary under Section 6 of S. 2305. We suggest these matters be clarified prior to enactment of the bill.

We are also concerned that the proposed legislation may encumber the authority the Interior Secretary already has under 25 U.S.C. 413 to collect reasonable fees to cover the cost of any work performed for the Indians. The Committee may wish to amend section 20 of S. 2305 to provide that the Secretary's authority under 25 U.S.C. 413 is not affected by the enactment of the proposed legislation.

This concludes my prepared statement. We would be happy to respond to any questions.

Senator **Wallop**. Thank you, Mr. Campbell. I can understand the recommendation you made that the bill might be changed to address the fact that it appears that Indian tribes do not share in any interest penalty payments, and I think that is OK, and it is valid so long as we get their agreement to share in the other side of it, the cost of the accounting.

I mean in the earlier hearing we had in here on the Linowes Commission it was flatly projected they wouldn't have any share as the States are anticipating by virtue of the one-half of 1 percent of the royalty payment. If that takes place, then the sharing the interest payment is obviously inequitable, but if it does not, it seems to me that ought to go the other way to the Government.

In your testimony as well as that of Mr. Linowes, you mentioned that there was no systematic way for Interior to know when new production begins on a lease.

The question that I would have is in two parts. Is this due to a problem in manpower management within Interior, or to omission in the laws and regulations relative to lessee reporting requirements?

Don't the regulations require lease operators to report when production starts on a lease and the same question that I asked Mr. Linowes—aren't all royalties paid on oil, on all oil and gas recovered even though Interior may get notice of production start 2 or 3 weeks after the fact?

Mr. **Campbell**. No accounting system will indicate when the production begins. As Mr. Linowes mentioned in his testimony, one of the problems in the past has been the inability to match reported sales against reported production. It has been on an honor system. The accounting system has not been able to provide accurate data.

The only way to satisfy ourselves that the sales on which royalties are computed and based are accurate and reliable is to know how much is being produced. That is why we are supporting the authority in this provision of the bill which requires by law that production be reported on the first business day.

Senator **Wallop**. What happens if you are in some of the more remote parts of Wyoming or even remoter parts of Alaska and you begin production? That first business day might be a real complication to you if you are an operator of that firm.

Mr. **Campbell**. I am not sure that the Department has worked out the procedures or methodology by which they are going to be notified on that first business day. I think any system is only as good as its implementation, but a couple of things are working in the Government's favor I think. The move toward greater lease inspections at the site. In addition the fact that there are civil and criminal penalties inherent in the legislation would serve somewhat as a deterrent and help insure all production is reported. Your question stems from the practicality of how to do that at a remote site. I am not sure those kinds of decisions have been worked out by the Department.

Senator **Wallop**. The testimony that you provided us characterized the fund as a self-sustaining fund. Is that how you read section 20?

Mr. **Campbell**. I am going to let our general counsel representative address that.

Mr. **Ruprecht**. The fun would be self-sustaining in the sense that the money will be earmarked from the royalty collection for royalty management purposes. This would set aside the money and you would have the money available.

Mr. **Campbell**. It is not a revolving fund if that is the question. As a matter of fact, as I understand it the money would be deposited in miscellaneous receipts and would have to be appropriated by the Congress as part of the annual appropriation.

Mr. **Ruprecht**. That is correct.

Senator **Wallop**. Well, I appreciate your testimony here this morning. We may have a specific followup question or two, but in the interest of time and getting everybody testifying, we will submit those to you.

Thank you very much for coming.

Mr. **Campbell**. Thank you very much, Mr. Chairman.

Senator **Wallop**. Next is Mr. Ken Cory, comptroller of the State of California.

STATEMENT OF KEN CORY, COMPTROLLER, STATE OF CALIFORNIA

Mr. **Cory**. I appreciate the opportunity of being here this morning and will try to give you some background on the comptroller's function to put what I have to say with the appropriate grain of salt.

With that, I would tell you that I am an elected official of California, and in addition to the accounting and auditing function for the State of California, I am also chairman of the State land commission which has a similar function of leasing property, and a lot of mineral leases. We are producing in excess of 100,000 barrels of oil a day on State property, and we are dealing with many of the problems that the Department of Interior is dealing with in its problems, so I am familiar with sort of both sides of it if you will.

I would also like to comment that before I was elected to my position of comptroller I served for 8 years in the State legislature so I am somewhat aware of the legislative side of things, and I am sitting here listening to some of what is going through, and I will shape my comments to be brief and at the same time to cover some points and have people listen to them because they are going to be I guess constructive criticisms as opposed to emphasizing the support areas.

I have some problems with Senate bill 2305, and I guess it starts from the fact that the figure that has been used here of 20 years of problems in this area, I would suggest that this area has been a problem for almost 30 years. The first GAO report I think was 1952 that criticized these, and I would like to emphasize at this point my comments do not relate to this administration or this Secretary. I think the record is clear that for at least 20 years and I would suggest approaching 30 years through numerous administrations, numerous Secretaries of differing political philosophies, there has been one constant—a poor administration of this royalty program.

As a former legislator and a citizen of this Nation, I am concerned about that, and I appeal to you as a legislator, Mr. Chairman, that it really is going to take a legislative solution, and I think the Department's proposal emphasizes the convenience of the bureaucracy that has not been responsive for in excess of 20 years, and I would suggest to you that with that repeated length of history of difficulty, it may be time to start getting two by fours out if you are going to move the mule. I have just got some doubts that you are going to overcome a department's lethargy that has existed for that length of time by just taking their proposal.

It has some good points, and I think the Linowes Commission is a step in the right direction, and the Secretary is to be commended for his timely attention, being new to the job, and I had I guess the misfortune of filing suit against the Secretary over this matter because we felt in California we were not being treated properly and we were asking for an accounting.

Perhaps putting it in perspective, the Department has suggested that suit is nonexistent. I would suggest to you I would like to clarify that. That lawsuit has been sort of suspended. We are not pursuing it, but it has not been dismissed. It is still there, and we are hoping that a cooperative effort would be helpful and that we can come to an early resolution, but there are some problems that indicate to me that perhaps we are not going to be able to do that, and the bill in its present form leaves me with continuing fears that there is not real teeth in it to require the Department of Interior to clean up its act, and there are pressures—working in an executive branch agency, I am aware of those kinds of pressures—but I think there are pressures to keep this. As soon as this attention and pressure is off, it is going to drift.

One of the things that I find most disconcerting is the fact that taking the timeframe, I would guess the best possible case of having the new accounting system in place is some time in 1985, and there is a record which indicates to me that the Department is not desirous of collecting underpayments that occur between now and 1985, or there is no great urgency on that, and I think when you have—the blame should not all be placed in the private sector, but if you have a lessor who has not been collecting its rent with vigor, and certain practices have built up over a long period of time, to then tell them well, in 1985 we are going to start doing a good job of collecting our rent, you in essence encourage those who would like to do some dastardly deed to continue to do so because our statement or the statements to us have been that we, that is, the Federal Government, is not planning on really pursuing with a great deal of vigor collecting the underpayments that are currently being made.

In our cooperative effort, the agreement called for I believe three or four auditors from each side of the Federal Government and the State of California. We produced in fact seven people. I believe the Federal Government had two, and recently added the third. We are more aware that there are manpower problems and a shortage of personnel. I sympathize with those, but if those exist, unless there is some real pressure, I am afraid that some of these underpayments will not be caught and will not be pursued, and the roughly 30 days that we had to look at those records—and this is not an audit. It is basically a records review. The indications are that there is about $6.5 million of underpayments on California onshore leases alone of oil properties. That is a significant amount of underpayment; when we looked at somewhere between 8 and 10 percent, you can say roughly 9 percent of the transactions.

I would caution you that that should not be a linear extrapolation because some of the higher volume items were looked at as opposed to a straight random sample, but I think somewhere in the neighborhood of $10 to $15 million of underpayments in the timeframe that we are looking at is indeed possible if the entire universe was looked at. With that kind of a pattern, to say to people gee, we are going to have this new accounting system, but it is not going to come on line until 1985, even if the owners and corporate managers, senior corporate managers, are running a good ship, there is going to be a tremendous pressure on a profit center employee who knows that he is not going to be checked up on very clearly to take some liberties.

The types of mistakes we are talking about relate to the value of the product, relate to the volume of the product, and we have been able to check them solely from the records that Interior has, not going to corporate records. We think that if we had access to the corporate records of the lessees we might find additional reasons to question even further underpayments so we are doing a rather cursory examination at this point.

In Chairman Linowes' recommendation he raised a question about the 1 percent off the top which is something I would like to underscore. I think what I understood him to say was that he was concerned as the Commission was concerned that the line responsibility of USGS tends to be the scientific commission that they have, and I well understand that and respect that mission.

However, the accounting function if it is taken off the top, it is not used for that specific purpose. Leaving aside the question of who is paying what share of it and all of that, I would like to underscore his concern that if that is not allocated for the accounting administration, accounting is likely to be given short shrift, and even in our short-term cooperative agreement, one of the difficulties has been the inability of the Department of Interior to allocate sufficient numbers of qualified personnel to do the job. You are not going to keep track of these leasehold records without good auditors adequately trained who are there in a career position where they can know they are going to be there. If the main mission of the scientific research is shortened or the geological research is shortened and they are able to pull that money out, we are going to slip back into this kind of problem, and I think it is one that should be addressed.

There is naturally the concern we have as to the existing laws seem to imply that we have no obligation to administer or to collect these funds, and this would be in essence taking one-half of 1 percent off the top. I would guess as a matter of equity I would have to say to you that I couldn't quarrel too much if the actual cost of that administration were shared. I couldn't say that that is a terrible public policy position for new legislation to take, but if w are going to do that, I would like to have some control on it or some indication since we are participating in paying for the overhead, and I am a little reluctant—in the lawsuit with the Department of Interior their defense was that they had no obligation to the State of California, nor to anyone else, to even make an accounting for the oil, so I am a little nervous about giving all of this to the Department of Interior given their track record of a defense. I hope that was overposturing on the part of their lawyers to defend a difficult position for them, but I have not yet in my own mind come to grips with the concept that they don't have an obligation to account for how much money they are taking in and from whence it is coming. I think that as public officials they have that obligation just to a citizen of the Nation to be able to justify why they are receiving what they are receiving.

The Interior proposal purports to continue the cooperative agreement approach, and I would suggest there is another piece of legislation, H.R. 5121, which provides more control or more input from the States. If we are going to pay part of that, we would like to participate in a fuller way. We think that we can provide rather quick implementation of a temporary accounting system until the federal system does come on line. We are prepared to do that. We would like to be reimbursed if in fact we do that.

From the State of California's perspective, we have similar problems that the Federal Government has. As of Monday of last week, we were internally borrowed to the tune of $1.8 billion on a $25 billion annual spending program, so we are broke. We don't have a great deal of money, and I, in essence, stole if you will seven auditors from other programs to put into this one to try to be cooperative, to be helpful. I can't do that in the long run without some form of covering the State's share of the costs.

I think both the State and the Federal Government can work cooperatively, but I think it is going to take legislation with real teeth in it to force the Department of Interior to change 20 to 30 years of bad habits, and I don't think the proposal as written really has those kind of teeth in it to really put the message from the legislative branch and the executive branch that you must do this. You have been called on by the General Accounting Office on numerous occasions, let's not have it happen again, and that is the thing. The bureaucracy always seems to outlast those of us in elective office, and they are able to repeat their sins, and I would hope that the legislation ultimately would put an end to this one because it seems to be rather clear. It seems to be nonpartisan that they should in fact clean up their act and solve the problem.

There are some institutional things such as Chairman Linowes suggested to you. If that money isn't earmarked for very specific purposes, it is going to be bled off for other missions, and I think that is extremely important.

That basically is our concern, but I would reiterate that given the track history and I reemphasize I am not talking about the Secretary or the administration. I am talking about an agency for a long period of time who really has not done a very good job under a multiplicity of administrations. I think it is important that the statute really spell out that they must change their ways rather than just give them more powers to do so if they choose. You can't believe that all Secretaries of Interior previously have been incompetent or inept administrators, or unwilling. There seems to be something else involved, and as an elected official, I have come to the conclusion there is a distinction between the elected and appointed administrations and the ongoing bureaucracy, and I think that is probably where the problem lies, and that is the group that needs to get the message.

I appreciate the time. If I can answer any specific questions, I will try to do so.

[The prepared statement of Mr. Cory follows:]

STATEMENT OF KEN CORY
CONTROLLER OF CALIFORNIA
TO THE
SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

May 3, 1982

My name is Ken Cory. I am Controller of the State of California and Chairman of the California State Lands Commission, which is responsible for managing the State's mineral resources. I appreciate this opportunity to testify on S.2305, the Interior Department's proposal for the long overdue reform of the federal royalty management system.

As a former legislator, I know the value of brevity so let me quickly summarize why we cannot recommend the enactment of S. 2305. Essentially, it merely clarifies Interior's existing but under-utilized authority for managing federal royalty interests, including its ability to use State agencies. Instead, we urge the enactment of H.R. 5121, now pending before the House Committee on Interior and Insular Affairs. That bill gives Interior even more authority to deal with the problems of collecting federal royalties, but, more importantly, it requires Interior to exercise these powers and provides for a more satisfactory basis for State action.

The need for a mandatory approach is clear from the long record of experience with the administration of the Mineral Leasing Act of 1920. That Act,as you know, sought to partially compensate the States because Federal public lands were exempted from their tax base. This was an especially serious problem in the West, where most of the States' land was thus exempted from taxation. The Act therefore directed that half the proceeds of minerals production on Federal land should be given to the State in which those proceeds are earned.

Some thirty years ago, however, the GAO first reported that Interior's royalty management procedures were wholly inadequate. Royalty obligations were not identified or enforced. Money received on account was not properly recorded. Interior promised to do better but somehow never fully succeeded.

The same pattern has been repeated by the Department over the last thirty years, regardless of the political affiliation of the various Secretaries of Interior. A detailed outline of that pattern which is attached to my statement was part of the latest GAO report, dated October, 1981. It lists eight consistent "Problems" which Interior has regularly acknowledged but were never solved.

One of the "Problems" identified as "Inadequate Valuation of Oil and Gas Prices for Royalty Purposes" is of significant concern. During the last ten years it was twice the subject of GAO study, twice verified by internal auditors in Interior, and is still a major problem. Indeed, considering that the price of oils generally has increased some ten-fold, the importance of adequately identifying the real price for the oils involved has proportionately increased.

It was because of this that California made a formal demand on the Department for an accounting. The Department denied that it had any responsibility to account to the States who were the beneficiaries of the Mineral Leasing Act. And so, reluctantly, just short of one year ago, California filed suit for an accounting.

Considering the budget crunch we are facing in California, you can easily understand our concern that Interior improve its collection procedures. It is not only a matter of principle -- it's the money.

The Department partially responded to this suit by appointing the Commission on Fiscal Accountability of the Nation's Energy Resources, an advisory committee chaired by David Linowes. However, in the answer to our complaint which the Department filed with the court, it denied that it has any enforceable duty to collect royalties from federal mineral leases. Soon thereafter, the Department filed a motion to dismiss our suit and again denied that it owes any duty to collect the royalties generated by federal mineral leases. We are presently exploring with the Department the possibility of settling this litigation, but progress has been remarkably slow.

Meanwhile, Congressmen Edward Markey and James Santini held a series of joint subcommittee hearings in the House Committee on Interior and Insular Affairs. These hearings made clear the need for a legislative solution to the historic and continuing failure of the Department of the Interior to collect royalties. Thus, on December 7, 1981, Mr. Markey and Mr. Santini introduced H.R. 5121, which I recommend that you adopt in its present form.

Soon after the introduction of H.R. 5121, the Department of the Interior and the State of California commenced negotiations for the settlement of the lawsuit. Although the Secretary had not altered his position that he is not under an enforceable duty to collect royalties, after several meetings these negotiations led to an agreement under which the litigation would be stayed while a joint State-Federal program of lease audits was conducted.

The joint effort conducted so far has merely been a review of United States Geological Survey records -- not a full audit of company records. It is clear from our brief look at the Department of Interior's records that our worst fears were realized. Although the price of oil has increased ten-fold since the GAO first pointed out the inadequacies in Interior's royalty collection system in 1952, the new system cannot be completed until 1985 at the earliest and the Department has neither the capability nor the willingess to collect past due royalties. Furthermore, in the course of implementing its new management system, Interior stopped collecting certain basic information which is necessary to verify production. Hence, in order to audit a lease acount effectively, it is now necessary to rely soley on the company's books. This places at risk literally hundreds of millions of dollars of public money will be lost.

During the one month, April 1982, since the agreement became effective, our auditors could examine less than 9% of the California federal royalty accounts from January 1977 to August 1981, yet found potential underpayments of over $6.5 million. No one knows how much more remains to be collected because, under our agreement with the Department, we cannot examine the producers' records to find out whether the Interior Department's records are accurate. Indeed, the Department itself does not have the capability to perform such audits in a timely manner, even though it has the authority to do so.

It is very important that our auditors continue to review the Department's records. There are large sums of money still there to be collected, but Interior lacks the capacity to perform this function and is apparently unwilling to try to get it. Clearly, its auditing manpower is busy with other tasks, such as training others in the use of the new accounting system. Second, the very nature of the bureaucratic structure makes it difficult to respond to the demands which an effective audit, or even a records review, places on the staff. Third, Interior purports to lack the funds necessary to pay California for its accounting efforts, even though under the Mineral Leasing Act, the administrative costs of royalty collection are the responsibility of the Federal Government.

Even our brief experience with this "cooperative agreement" emphasizes the need to take the approach embodied in the Markey-Santini bill (H.R.5121) instead of that proposed by Interior in S. 2305. Where the Interior proposal would merely continue the "cooperative agreement" approach which is so unsatisfactory, H. R. 5121 provides that States which ask for the responsibility and demonstrate their capability would receive full authority to act. And that authority would continue without fear of any bureaucratic whim, until the State is shown to be incapable of exercising it.

Again, the expense of royalty management will be borne wholly by the States under the Interior proposal. H.R. 5121 more appropriately retains the federal obligation originally established by the Mineral Leasing Act. Finally, the obligations of Interior to improve its royalty management, and to assist the States assuming enforcement duties, is made clear under the Markey-Santini bill. Under Interior's scheme, it will simply receive clearer discretionary authority to do that which it is already authorized to do, but has so far refused to do.

This is most clearly an example where President Reagan's New Federalism approach could be constructively used. Let the authority and responsibility be shifted to the State level of government, where it can be most effectively performed. But let the States also receive payment for their work, and let them act as States, not mere servants of a Federal agency.

Problems at Geological Survey Reported On by GAO and Department of Interior Internal Auditors

Problems	Reported by GAO	 Internal auditors
Reliance on oil and gas company data for computation of royalty payments	December 1959 February 1972 April 1979	June 1975
Inaccurate lease account records--large debit and credit balances distorting accounting records	December 1959 April 1979	June 1975
Inadequate audits and reconciliations of lease accounts	December 1959 April 1979	June 1975 February 1977
Royalties collected late or not collected in full	December 1959 April 1979	June 1975
Charging interest on late payments	April 1979	June 1975
Sales and production data not verified	February 1972 April 1979	June 1975 February 1977
Inadequate valuation of oil and gas prices for royalty purposes	February 1972 April 1979	June 1975 May 1980
Staffing problems not adequately addressed	April 1979	June 1975

Senator **Wallop**. Mr. Cory, I think in order to set the record straight, we are talking about the Department cleaning up its act and everything else. This legislation is not really the Department's, although it came from there, but it is, with the exceptions noted in section 12 and other things, the direct recommendations of the independent Linowes Commission, so it is not as though there is kind of some sort of internal bureaucratic resistance to change. It is a very direct response to very direct independent recommendations, and I don't think it is really fair to characterize it as you have, that this is a sort of departmental means by which bureaucrats cover up 20 years of past inaction on the threshold of 20 years of future inaction.

Mr. **Cory**. The question in comparing this bill with the House bill, S. 2305 primarily is a statement of policy options that the Secretary can, as opposed to you shall, do something.

Senator **Wallop**. That may be. I am not quarreling with the distinctions in the two bills. All I am saying is that it is a very direct implementation of the independent commission. While there may be things that should be done to it, I am just trying to set their role in it as being rather quickly responsive to an independent commission that was set up.

Mr. **Cory**. I didn't mean to imply it was not quick, Mr. Chairman. What I was trying to say is that given the fact that the problem has been discovered and rediscovered in numerous GAO reports, I would suggest to you that just leaving it entirely with the Department has not been, they have not brought a long-going solution in the past.

Senator **Wallop**. Is California presently negotiating with Interior to institute a cooperative agreement some time?

Mr. **Cory**. We have a cooperative agreement. The records inspection that I made reference to is a result of that cooperative agreement. There was a sequence of events. We sued the Department. They offered the olive branch if you will. We suspended further active pretrial part of the litigation as we have pursued the agreement. The agreement provided for the records review which has gone on. The Department has done the best it could with the personnel it has as best as I can tell in that cooperative agreement, but the records show that there have been underpayments, and they have made some billings on those, have sent out questions of inquiry to the lessees to see what adjustments can be made, but the indications from the cooperative agreement from our vantage point indicate that the agency is significantly understaffed in the accounting function, and that their timeframe is 1984 to 1985 before the new system is going to be implemented, and I think that is far too much time when oil is selling for $25, $30 a barrel before we get a solution in place.

Senator **Wallop**. Is California one of the States subject to look-back audit, or is California doing that all on its own?

Mr. **Cory**. I am not sure that I understand the question, sir.

Senator **Wallop**. Well, I mean there are several States that are having a look-back audit now. Is California one of those or are the findings that you have brought to the attention of the committee things which California has done all by itself?

Mr. **Cory**. This is as a result of the cooperative agreement.

Senator WALLOP. So there is an active look-back audit going on?

Mr. CORY. Yes. Let me clarify that. It is not an audit. All we are doing is looking at the records in Colorado of those leases, and for example, since 1979 run tickets——

Senator WALLOP. Looking at records of Colorado?

Mr. CORY. Records of the Federal Government stored in Colorado, the center in Colorado, and those records are inadequate to conduct an audit.

We do not have access to the lessee records to ascertain what is happening in the companies. One of the things that we have discovered is that since 1979 they basically have not collected the run tickets. All they have is an overall report so you don't have the beginnings of the working papers to really do an audit.

Senator WALLOP. Thank you very much, Mr. Cory. Next is Mr. Charles DiBona, president of the American Petroleum Institute.

STATEMENT OF CHARLES J. DiBONA, PRESIDENT, AMERICAN PETROLEUM INSTITUTE; ACCOMPANIED BY DALE GILLIAM, GENERAL MANAGER OF PRODUCTION, AMOCO PRODUCTION CO.

Mr. DIBONA. Thank you, Mr. Chairman. My name is Charles DiBona. I am president and chief executive officer of the American Petroleum Institute which represents more than 300 large and small companies and about 8,000 individual members.

With me today is Mr. Dale Gilliam, general manager of production for the Amoco Production Co. He is here in his capacity as chairman of the API committee that has analyzed the report of the Commission on Fiscal Accountability of the Nation's Energy Resources and the proposed legislation.

In the interest of time, I would simply submit my statement for the record and give a brief set of excerpts from it, if that is all right.

Senator WALLOP. The statement shall be entered in the record.

Mr. DIBONA. We endorse the stated purposes of S. 2305 which are to improve the mineral leasing laws, to help the Secretary of the Interior gather necessary information, and to insure prompt and proper collection of all mineral resources revenues due as a result of production from leases on Federal and Indian lands.

We stand ready to support workable legislation to advance these purposes. We believe every producer should pay the royalties required by law, lease terms, or contracts, no more and no less. We naturally want to eliminate oil thefts which defraud both the Government and the producers.

Although we support the objectives of the legislation, we are concerned that some of the Commission's recommendations and parts of the proposed bill are extreme and in the end could be counterproductive. Some provisions of the bill appear to flow from the assumption that the most extreme claims of witnesses before the Commission are correct. We believe they are not. The Commission report itself clearly states that the members cannot determine how much revenue the Government loses because of royalty underpayments or oil theft.

Moreover, the Commission does not ascribe to lease holders any widespread intent to defraud the Government or the Indian tribes.

A clear understanding of what the report does and does not demonstrate is important in deciding what this proposed legislation must do.

As drafted, the proposed bill would not provide an effective solution to the problems that it addresses. The bill goes beyond either what the Commission recommended or what is needed. However, we believe that with certain modifications the bill can help to reduce oil theft and bring greater efficiency to the royalty management system.

We are especially concerned about three broad aspects of the bill. I can summarize them as follows. First, the bill would delegate to the Secretary of the Interior sweeping authority with virtually no bounds in the exercise of his discretionary powers.

Second, the bill proposes significant changes in existing policies. If applied retroactively to existing leases and contracts, this could be manifestly unfair if it impairs the rights of those affected, and could be particularly inequitable in the area of valuation of oil and gas production for royalty purposes.

Third, the bill would make unlawful a litany of actions without providing adequate criteria for distinguishing between mere technical infractions and substantial violations.

Moreover, harsh penalties of a civil and criminal nature are proposed, penalties totally out of proportion to the offenses involved.

Together we believe these aspects of the bill could discourage the development of mineral resources on Federal and Indian lands at a time when this country needs more development. The legislation could have a particularly chilling effect on small producers, and it would needlessly increase administrative burdens for the Government, ultimately increasing prices that consumers must pay.

Now most of the specific cases cited in the Commission's report revolve around disputes over the valuation of natural gas, and I will provide some information on that separately to you, but rather than going into that, I will just skip ahead.

Another thing that has troubled us is that we have seen news media reports indicating that there were no overpayments of royalties, that these never occur. Mr. Linowes again repeated this claim in a more narrow context, but the fact is that producing companies often find they have paid the Government more royalties than were required, and in fact we did send, two companies did send letters to the Commission which indicated overpayments, in fact, which indicated not only individual overpayments, but for those two companies, over a substantial period of time, net overpayments for the period involved, so there is simply no truth to the statement that there are not overpayments. There are overpayments, and in some instances quite substantial ones.

As for the subject of oil thefts, companies have been giving very high priority to improving their security arrangements and have been doing so for some time. There are a number of organizations set up. We have been working with a whole host of law enforcement officers in changing our procedures and doing a number of other things. Our personal view is that the thefts of equipment exceed the thefts of oil by a substantial amount, and a good deal is being done about that.

In the time remaining I would like to address my remarks to some specific provisions of the bill. Section 4 of the bill would allow the Secretary to make retroactive changes in existing leases, to alter existing permits, and to make significant changes in contractual agreements, thereby upsetting the arrangements and relationships on which persons have relied for years.

It could also give the Secretary unduly broad powers with respect to the valuation of oil and gas production for royalty payments. Similarly, it could empower the Secretary to make unreasonable requests for information from a producer concerning activities well down the market stream that is far away from his production, information which we believe is not relevant to the payment of royalties. That does not mean we disagree with the notion of having run tickets. We can agree with that, oil producer reports, and reports for sales, all of these things. We are talking about much further downstream.

Existing laws give the Secretary considerable authority to improve the royalty management system and protect the public interest. Any additional powers that are shown to be necessary should be carefully defined and provided with meaningful bounds, and it is those concepts that are particularly troublesome to us in this legislation.

We urge that section 11 be deleted in its entirety. We have a number of specific reasons, but I think you have already touched on some of them. We urge the Congress to revise section 13 of the bill. That section would require producers to pay royalties on several categories of oil and gas that are now specifically exempt under terms of many existing leases and contracts. These categories include fuels used on the lease to operate production equipment, gas that is reinjected into the Earth to enhance oil recovery, and other categories of that sort.

To the extent that this section would allow substantial alterations in the terms of existing leases, it would unfairly burden parties who have been operating under these leases for many years.

We recommend that civil penalties proposed in section 15 be reduced to reasonable levels and that the criminal penalties in section 16 be deleted as unnecessary. There are laws which do penalize the receipt of stolen goods. We believe the huge fines imposed in this bill vastly exceed the penalties recommended by the Linowes Commission.

The Commission recommended that civil penalties imposed be similar to those applied by the Internal Revenue Service, but the penalties proposed in this bill would exceed those in existing tax law by an order of magnitude.

Moreover, the IRS forgives penalties for underpayments that were based on reasonable, good-faith belief that proper payment was being made, and we believe this bill should do the same.

Next-day notification—we recommend the deletion of language from section 5(c)(1) that would require operators to notify the Secretary on the first business day after any new well begins production. Contrary to some of the previous testimony, USGS does get sales and production data now. It gets both of these things. We think it should be sufficient to require the report 5 days after production starts. When you combine the requirement of next-day reporting and the penalties associated with that which are extreme, people would very likely not start production until they were sure that the USGS had in fact received receipt of the information. We just think this is kind of a totally unnecessary thing.

Providing the information as to when it starts within 5 days certainly ought to serve the needs of the Minerals Management Service.

Finally, we recommend the deletion from section 5(b) of a proposal that operators be required to develop and comply with site security plans for wells on the Outer Continental Shelf. We just think this is unnecessary. There is little chance for physical theft from such facilities, and there are a number of other measures, including careful metering, that would detect such losses.

Mr. Chairman, we believe the revisions we have suggested will improve accountability in the royalty management system and result in a more effective piece of legislation, and we are very interested in working with you.

We will leave with the staff a marked copy of the bill containing our specific suggestions for revisions and reasons therefor, and a commentary on the Linowes Commission report which we would be happy if you would place in the record.

Thank you, sir.

[The prepared statement of Mr. DiBona follows:]

Statement by

Charles J. DiBona
President, American Petroleum Institute

on behalf of the

AMERICAN PETROLEUM INSTITUTE

before the

COMMITTEE ON ENERGY AND NATURAL RESOURCES
UNITED STATES SENATE

May 3, 1982

My name is Charles J. DiBona. I am president and chief executive officer of the American Petroleum Institute. The API represents more than 300 large and small companies and about 8,000 individual members.

With me today is Mr. Dale Gilliam, general manager of production for the Amoco Production Company. He is here in his capacity as chairman of an API committee that has analyzed the report of the Commission on Fiscal Accountability of the Nation's Energy Resources and the proposed legislation. We appreciate this opportunity to appear before the Committee.

We endorse the stated purposes of S. 2305, which are to improve the mineral leasing laws, to help the Secretary of the Interior gather necessary information, and to ensure prompt and proper collection of all mineral resources revenues due as a result of production from leases on federal and Indian lands.

We stand ready to support workable legislation to advance those purposes. We believe every producer should pay the royalties required by law, lease terms or contracts -- no more and no less. We naturally want to eliminate oil thefts, which defraud both the government and producers.

We in the petroleum industry are just as concerned as the government regarding the need to preserve the integrity of the system under which we produce oil and natural gas from government and Indian lands for the use of all Americans.

Government and industry studies agree that a major portion of this country's future energy supplies may be found beneath those lands.

For the past several years, government reports have called attention to problems in the royalty management system. The Secretary of the Interior has reorganized his department and has begun introducing modern accounting procedures. When those procedures are fully implemented, we believe they will eliminate many of the problems of the past.

Although we support the objectives of the legislation, we are concerned that some of the Commission's recommendations and parts of the proposed bill are extreme and in the end could be counterproductive.

Some provisions of the bill appear to flow from an assumption that the most extreme claims of witnesses before the Commission are correct. We believe they are not correct. The Commission report itself clearly states that the members could not determine how much revenue the government loses because of royalty underpayments or oil theft. Moreover, the Commission does not ascribe to lease holders any widespread intent to defraud the government or the Indian tribes. The report states, "Underpayment often results from a defensible interpretation of a complex set of rules."

Despite those disclaimers, press releases issued by the Interior Department and statements by at least one member of the Commission have led to media reports suggesting that the extent of losses has been clearly established as fact and that the government is losing as much as $500 million to $650 million a year in oil and gas revenues.

Neither the Commission report nor the record of its proceedings provides verifiable evidence to support such assertions.

A clear understanding of what the report does and does not demonstrate is important in deciding what this proposed legislation must do. We believe the report, in part, and departmental press releases to a greater degree grossly exaggerate the size of the problem. We believe that parts of this proposed legislation reflect that overstatement.

As drafted, the proposed bill would not provide an effective solution to the problems it addresses. The bill goes beyond either what the Commission recommended or what is needed. However, we believe that with certain modifications the bill can help to reduce oil theft and bring greater efficiency to the royalty management system.

Flaws in the Legislation

We are especially concerned about three broad aspects of the bill. I can summarize them as follows:

First, the bill would delegate to the Secretary of the Interior sweeping authority, with virtually no bounds on the exercise of his discretionary powers.

Second, the bill proposes significant changes in existing policies. If applied retroactively to existing leases and contracts, this could be manifestly unfair if it impairs the rights of those affected, and could be particularly inequitable in the area of valuation of oil and gas production for royalty purposes.

And, third, the bill would make unlawful a litany of actions without providing adequate criteria for distinguishing between mere technical infractions and substantial violations. Moreover, harsh penalties of a civil and criminal nature are proposed -- penalties totally out of proportion to the offenses involved.

Together, we believe these aspects of the bill could discourage the development of mineral resources on federal and Indian lands at a time when this country needs more development. The legislation could have a particularly chilling effect on smaller producers. It could needlessly increase administrative burdens for the government and for energy producers and could increase the cost of oil and gas production, thus affecting the prices consumers would pay.

Royalty Payment and Theft Problems

Most of the specific cases cited in the Commission's report revolve around disputes over the valuation of natural gas. These disputes do not represent any attempt to defraud the government. They are open, bona fide disagreements over the interpretation of complex regulations. Under the present system of natural gas price controls, different regulations apply to each of some two dozen categories of gas production. Under the circumstances, differing interpretations are inevitable.

At times the Federal Energy Regulatory Commission will assign one value to a certain kind of gas, while the Interior Department will give it a higher value for royalty purposes. The producing company then is caught in the middle. Some disputes wind up in court. When all issues are settled, the government collects what it is entitled to collect.

We have seen news media reports indicating that no overpayments of royalties occur. But the fact is that producing companies often find that they have paid the government more royalties than were required. When such errors are discovered by the companies or the government, the companies apply for refunds. Under existing law, the refund procedure is often extremely time-consuming. We are pleased to note that the bill endorses streamlining the process.

As for oil thefts, companies are giving high priority to improving their security arrangements, and have been doing so for some time. When thefts occur, the revenue loss to the producing companies is far greater than the loss to the government. And despite the Commission's attempt to discredit that argument, the loss to the producer is a powerful incentive to prevent theft.

If standards for site security are established, our concern is that they reflect the realities of the oil field. Production facilities are located in radically different environments, and production levels vary greatly from lease to lease. Therefore, no rigid set of rules can be appropriate for all situations. In this regard, API has already established a committee to participate in the site security rulemaking just recently commenced by the Department of the Interior.

In the time remaining, I should like to address my remarks to some specific provisions of the bill and to suggest ways in which we think it could be made more effective.

Powers of the Secretary

Section 4 of the bill would allow the Secretary to make retroactive changes in existing leases, to alter existing permits, and to make significant changes in contractual agreements, thereby upsetting arrangements and relationships on which persons have relied for years. It could also give the Secretary unduly broad powers with respect to the valuation of oil and gas production for royalty payments. Similarly, it could empower the Secretary to make unreasonable requests for information from a producer concerning activities well down the market stream, information not relevant to production and the payment of royalties.

Existing laws already give the Secretary considerable authority to improve the royalty management system and to protect the public interest. Any additional powers that are shown to be necessary should be carefully defined and provided with meaningful bounds.

Valuation of Production

We urge that Section 11 be deleted in its entirety. First, Section 11 is simply unclear, having an uncertain impact on valuation of production and an uncertain relationship with Section 4 -- which, as noted above, is very broad. Second, Section 11 would do nothing to advance the stated purposes of the bill: improving the leasing laws, helping the Secretary gather information, and ensuring collection of royalties due. Third, it appears to go beyond the Linowes Commission report, which suggests that federal royalty managers develop guidance for determining fair market value by July 1983. In this regard, the Department of the Interior has already commenced that process with a notice in the Federal Register for April 16.

Fourth, to the extent that it would permit the Secretary to ignore existing contractual relationships and past regulatory policies, it could be manifestly unfair, impairing the rights of parties operating under long-standing agreements.

Expansion of Royalty Obligations

We urge the Congress to revise Section 13 of the bill. That section would require producers to pay royalties on several categories of oil and gas that are now specifically exempted under terms of many existing leases and contracts. Those categories include fuels used on the lease to operate production equipment, gas that is reinjected into the earth to enhance oil recovery, and oil and gas that is lost or wasted because of some emergency or accident beyond the control of the operator. To the extent that this section would allow substantial alterations in the terms of existing leases, it would unfairly burden parties who have been operating under those leases for many years.

Penalty Provisions

We recommend that the civil penalties proposed in Section 15 be reduced to reasonable levels and that the criminal penalties in Section 16 be deleted as unnecessary.

The huge fines proposed in this bill vastly exceed the penalties recommended by the Linowes Commission. The Commission recommended that the civil penalties imposed be similar to those applied by the Internal Revenue Service. But the penalties proposed in the bill would exceed those in existing tax law. Moreover, the IRS forgives penalties for underpayments that were based on a reasonable, good-faith belief that proper payment was being made. This bill should do the same.

Similarly, the Commission did not recommend any criminal sanctions. We believe that new criminal penalties are completely inappropriate. The existing federal penalties for theft and fraud are sufficient.

'Next-Day' Notification

We recommend the deletion of language from Section 5(c) (1) that would require operators to notify the Secretary on the first business day after any new well begins production. Existing laws provide that royalty obligations begin with the first movement of oil or gas off the lease, and penalties are prescribed in existing laws for inaccurate or false reporting. It should be sufficient to require a report five days after production starts. This would not change the amount of royalties to be paid.

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Security of Offshore Wells

We recommend the deletion from Section 5(b) of a proposal that operators be required to develop and comply with site security plans for wells on the Outer Continental Shelf. Such a requirement is clearly unnecessary, because the security problems that may apply to some onshore wells do not apply to platforms located 50 to 100 miles out to sea and accessible only by boat or helicopter. The Commission's report noted that "most of the discussion of theft before the Commission concerned oil (not gas) from onshore (not offshore) leases."

On April 21, the Minerals Management Service published in the Federal Register a notice of intent to develop regulations requiring site security plans for onshore leases. However, the agency has given no indication that it intends to require similar plans for offshore wells.

It would seem appropriate, in fact, to eliminate OCS coverage entirely from this bill.

Mr. Chairman, we believe the revisions we have suggested will improve accountability in the royalty management system and will result in a more effective piece of legislation. The timely development of this country's energy resources is one of the greatest challenges facing the American people. It is our earnest desire to cooperate with the government in achieving that goal.

Senator WALLOP. Thank you very much, Mr. DiBona. One of the things that you mentioned is the broad authority which you feel is given to the Secretary in certain sections of the bill which could operate to allow him to retroactively impair the contractual lease rights presently enjoyed by oil and gas.

Mr. DIBONA. Yes, sir.

Senator WALLOP. Could you provide us either today or shortly with some specific examples just how that operates?

Mr. DIBONA. Yes. We certainly will.

Senator WALLOP. The same would be true with the site security issue that you mentioned. I gather it is your opinion that there can be no, or it is virtually impossible to have that oil on offshore sites——

Mr. DIBONA. Yes, sir. We would be happy to provide you with that. These things are physically located out in the water. They generally are manned, and the notion that someone could back up to them and physically steal—there are no tanks out there or any other facilities.

Senator WALLOP. I understand that. I just think it would be useful to have that information for the record.

Mr. DIBONA. We will certainly be happy to provide that.

Senator WALLOP. You also mentioned the bill as presently drafted would allow unfair penalties to be imposed against lease operators for mere technical infractions.

Could you cite for the committee what sort of examples?

Mr. DIBONA. We put together two or three parts of this legislation. Then someone who makes a minor statistical recording error, say three errors in one document that persisted for 10 days, could conceivably be given a bill of $75,000 a day for 10 days. That would be $750,000 in penalties.

Senator WALLOP. Your feeling is that the authority——

Mr. DIBONA. This bill will permit you to do that, because he is permitted in the earlier section to—let me get the bill itself in front of me—to issue rules and regulations, and then in a later section, is permitted for any infraction of those rules to levy $25,000 a day for each infraction, and it is because of the very loose wording of the bill that such things are possible.

Now that would far exceed any reasonable penalty, and presumably people wouldn't behave that way, but we think that the interest of the Government and any operator would be better served by a more explicit listing of those things that are considered punishable offenses, and then a more reasonable level of penalty more consistent with what the Linowes Commission had in fact suggested which are those similar to the IRS rules.

Senator WALLOP. You don't think the electric chair is appropriate?

Mr. DIBONA. We were a little worried when we read this bill.

Senator WALLOP. One of the problems that the legislators always have, frankly, is the problem that when you get a specific listing of technical infractions, then by omission you are prepared to authorize certain other actions which we would not have here on the staff.

Mr. DIBONA. You don't have our specific recommendations here yet. We are giving them to your staff now. We think this can be cured by the introduction of a few words like "reasonably necessary," the so-called rule of reason. I am not a lawyer, but I understand that there is such a principle. It does not enter into the language of this bill, and all we are requesting is that that kind of language be inserted.

Senator **Wallop**. In your testimony, the written one, you indicate that API believes that the report of losses of $600 to $650 million a year is incorrect and perhaps grossly exaggerated.

Has your association conducted its own investigation?

Mr. **DiBona**. No, we have not. The basis for these numbers of $500 and $650 million that appeared in press reports and some of which appeared in the press releases of the Department of the Interior appear to be based on taking the statement of up to 7- to 10-percent loss which the GAO report referred to a range that could conceivably have been from zero to 10 percent, and taking the highest percentage of that, that is 10 percent, and multiplying it initially by what was expected to be the future collections of royalties, $6.5 billion in 1982 which was reduced to $5 billion subsequently, and it is 10 percent of that number, so it takes the extreme upper end of the range and multiplies it by a future collection of royalties.

The only other possible way you got a number like $650 would have been to take that 10 percent plus 6 percent which was the upper end of the range of possible theft, 16 percent, and multiply that by 1981's total collections which were about $4 billion, and that would appear to be $640 million. Now either one of these calculations strikes us as being an extreme calculation, particularly the latter one which implied that 6 percent of offshore and onshore gas was being stolen. Now 6 percent of even the onshore oil in the United States would require, if it were stolen by truck, 830,200 gallons large truck, barrel truckloads moving on the road. I mean literally we would be run over by these things. There would be no possible way.

Senator **Wallop**. I don't think the implication is it is all stolen. I think there is some implication there are other accounting practices which account for some of the shortfall, but be that as it may, I wonder, before the Linowes Commission in testimony here took issue with the statement which you have just made, and they made it before about the numbers of overpayments that may or may not exist.

Could you supply for the committee any evidence you have?

Mr. **DiBona**. I will supply to you the two letters—in fact, there were three letters sent. Two of them show overpayments that were sent and received by the Commission after testimony was given. This question was raised by the Commission. I will be happy to supply those for the record.

Senator **Wallop**. I do know in Wyoming at the moment under that audit that is going on over there, they have found very recently one pretty substantial overpayment, but it has not been their ordinary find.

Mr. **DiBona**. Yes.

Senator **Wallop**. Their ordinary find has been quite the opposite.

Mr. **DiBona**. I don't know. The report today, the press report today suggested that there was something on the order of 50 audits that have been conducted. I don't know whether there was any selection of those audits, whether or not they purposely looked for cases which they thought were probably underpayments, but for a company that—one of these companies is Exxon, and it had a net overpayment last year or 18 months of about $1.9 million, had many overpayments and many underpayments, but there are a number of overpayments. This was, as I said, reported to the Commission so we were a little surprised to see the Commission or at least press reports that were not refuted by the Commission that suggested that there were no overpayments.

Senator WALLOP. As I say, they have taken issue with that in the past, and it would be useful for us to have that information.

Mr. DIBONA. We will provide that information.

Senator WALLOP. Thank you very much, sir. We appreciate it.

Mr. DIBONA. Thank you.

Senator WALLOP. We will probably as well have some follow-up questions on your recommendations.

Mr. DIBONA. We will be happy to answer them.

Senator WALLOP. Next is a panel of Mr. Saul Goodman, who is an attorney for the firm of Rogovin, Huge & Lenzner, representing the Shoshone and Arapahoe Tribes, the Wind River Reservation, Wyo.; Mr. Ed Gabriel, former director of the Council of Energy Resource Tribes, Washington, D.C., accompanied by Mr. John Butler, senior economist presently for the Council of Energy Resource Tribes.

Gentlemen, proceed. As with other witnesses, it would be helpful if you could summarize your testimony.

STATEMENT OF SAUL GOODMAN, ROGOVIN, HUGE & LENZNER, ON BEHALF OF THE SHOSHONE AND ARAPAHOE INDIAN TRIBES, WIND RIVER RESERVATION, WYO.

Mr. GOODMAN. Good morning, Senator Wallop. My name is Saul Goodman. I am an attorney with the law firm of Rogovin, Huge & Lenzner. I appear today representing the Shoshone and Arapahoe Tribes.

As you know from prior hearings, the Shoshone and Arapahoe Tribes undertook in November of 1980 an investigation of allegations of theft and underreporting of royalties on their reservation. The leases that they investigated were tribal leases held in trust for the tribes by the Department of the Interior.

As a result of the investigation, the tribes have learned that the leases have been seriously mismanaged for many years. In the written testimony which we have submitted we outline in detail some of the problems that the tribes have encountered.

The tribes discovered that the oil companies were on an honor system insofar as royalty accounting is concerned. The companies were expected to report and pay the proper amount of royalties, but unfortunately, the tribes discovered that they had not. As a result, the tribes have recovered more than a million dollars in previously unpaid royalties.

There are other problems with the royalty management system. Until last year, there was no charge, no interest charge, for late payment of royalties. As a result, the lessees were essentially invited to take interest-free loans from the tribes simply by paying their royalties in an untimely fashion. Similarly there exists even today a procedure whereby the tribes were losing a substantial amount of royalty interest because the checks sent by the oil companies to the tribes are received in a Government office in Casper, but not cashed there, simply logged in, mailed to another Government office in Fort Washington, Wyo., again logged but not cashed, and then mailed on again to the Bureau of Indian Affairs office in Billings, Mont., where they are cashed for the first time.

This falls something short of a prudent management of the tribal resources, and yet this is the sort of management that the tribes are now being asked to pay for—more on that later.

Other problems that the tribes have encountered have related to field operations on the reservation. There have been two criminal convictions relating to the theft of oil from the Shoshone and Arapahoe Tribes, and in addition, tribal investigators have uncovered numerous violations of USGS regulations regarding site security in field operations.

The conclusions of the Shoshone and Arapahoe Tribes are found in much broader scope in the Linowes Commission report. The tribes are in agreement with the vast majority of the Linowes Commission recommendations and are pleased to find that many of the recommendations have been incorporated in S. 2305. Unlike some of the prior testimony, we do not feel that these are unfair. We do not feel that the conclusions of the Linowes Commission by way of under-reporting of royalties are at all overstated.

To the contrary, we feel that there are serious royalty accounting problems and that adequate incentives need to be built into the laws to insure that the oil companies will pay their royalties in a timely fashion.

Were the tribes to part company with the proposal being advanced by the Department of the Interior, it would be with regard to section 20 of that bill. Section 20 would require the Indian tribe to contribute up to 1 percent of their royalties to a fund to be used for royalty accounting purposes. In effect, the tribes would be required to pay the fund for the royalty management services of the Department of the Interior, at least to contribute a pro rata share.

It is the view of the tribes that in light of what they have discovered during this investigation and what the Linowes Commission has concluded, that is, that these leases have been seriously mismanaged for years, the tribes do feel it is simply unfair to be asked to pay for these services. The services have been inadequate. The tribes have been required to put out a lot of money to bring the lease accounts into order now. The tribes have no assurance that they can stop investing, that they ought to stop investing their money now, but rather they must keep a careful eye to insure that things will be taken care of properly in the future, and in addition, although they have recovered substantial royalties, there are certain problems that occurred in the past that they may never be able to fully recover their losses for.

Under these circumstances, the tribes simply feel that it would be unfair to be asked to pay the burden for these services that in the past have been so woefully inadequate.

Beyond that, if section 20 were enacted and the tribes were required to pay for these services, they believe that the Government ought not to exact anything more from the tribes than is reasonably necessary to provide services for the tribes. They believe it would be a breach of fiduciary duty to use tribal funds to pay for the royalty accounting on nontribal leases, and in this regard they are somewhat concerned by the manner in which section 20 is now drafted which provides for contributions after consideration of the windfall profits tax. Since the tribes are exempt from that tax, a greater proportion of the tribal royalties would be kicked into the proposed fund than would be kicked in from Federal leases.

For all these reasons, although the tribes are in support of virtually all of the provisions of this bill, we would object, however, to section 20. We do not believe the tribes should have to pay for these services.

[The prepared statement of Mr. Goodman follows:]

TESTIMONY OF THE
SHOSHONE AND ARAPAHOE TRIBES
OF THE WIND RIVER RESERVATION
REGARDING S. 2305
BEFORE
THE SENATE COMMITTEE ON ENERGY AND NATURAL RESOURCES

WASHINGTON, D.C.
MAY 3, 1982

MITCHELL ROGOVIN, ESQ.
SAUL GOODMAN, ESQ.
ROGOVIN, HUGE & LENZNER
A PROFESSIONAL CORPORATION

The Shoshone and Arapahoe Indian Tribes are the joint lessors of 97 producing oil and gas leases on the Wind River Reservation in Wyoming. Eighty-five percent of the royalties derived from these leases is distributed to individual tribal members, and the remaining fifteen percent is used for tribal government. Inasmuch as this royalty income plays an important role in the economy and governance of the Wind River Reservation, the Shoshone and Arapahoe Tribes greatly appreciate this opportunity to testify before the Senate Committee on Energy and Natural Resources regarding S. 2305.

In November 1980, the Tribes launched an investigation into allegations of theft and underreporting of royalties on tribal leases on their Reservation. This inquiry was initiated following published reports that a federal grand jury in Wyoming had begun a similar investigation. Since then, there have been four criminal convictions, two involving theft of oil from leases on the Wind River Reservation. In addition, the Department of the Interior has conducted its own inquiry through the "Linowes Commission," and this Committee and other congressional committees have held hearings on problems with royalty management and site security on federal and Indian leases.

What the Tribes learned during their investigation is that the Wind River leases, which are held in trust for the Tribes by the Department of the Interior, had been seriously mismanaged: In regard to royalty collection, the Department had relied on an "honor system" under which the oil companies were expected to report and pay the correct amount of royalties. For years, there had been virtually no governmental auditing of the source documentation underlying tribal leases accounts. Not surprisingly, the honor system was a dismal failure. During the course of their investigation, the Tribes recovered more than a million dollars in previously unpaid tribal royalties from major oil companies.

Moreover, even though the Department of the Interior has a fiduciary duty to manage tribal leases prudently, it was not until last year that the Department first required the oil companies to pay an interest charge for late royalty payments. Before then, the oil companies were permitted to write themselves what amounted to interest free loans from the Tribes by simply not paying their royalties in timely fashion. Even today, the Department continues its inexcusable practice of mailing uncashed royalty checks from the oil companies twice -- first, from the Minerals Management Service office in Casper, Wyoming to the Bureau of Indian Affairs office in Fort Washakie, Wyoming, and, then, from there to the Bureau of Indian Affairs office in Billings, Montana -- before the checks are cashed and credited to an interest bearing account.

There were also serious problems with field operations and site security on the tribal leases on the Reservation. One oil company was even found to have installed an underground bypass of the metering device on its leases. Moreover, as mentioned above, there have been two criminal convictions for theft of oil from the Tribes. As a result of the problems with site security and field operations on the Reservation, the Tribes will never know how much oil was removed from their leases without royalty payment.

During their investigation, the Tribes became painfully aware that the Wind River leases had long been mismanaged. Thus, it came as no surprise that the Linowes Commission reached a similar conclusion regarding all federal and Indian leases. According to the Linowes Commission, the "[m]anagement of royalties for the Nation's energy resources has been a failure for more than 20 years." Report of the Commission on Fiscal Responsibility of the Nation's Energy Resources, at xv. In the view of the Linowes Commission, there have been substantial royalty underpayments. "The results of individual audits," the Commission concluded "suggest that hundreds of millions of dollars due the U.S. Treasury, the States, and Indian tribes are going uncollected every year." Id. Although unable to document the precise amount of royalties lost to oil theft, the Linowes Commission found that "security at many Federal and Indian lease sites is lax and is an open invitation to theft." Id.

The Linowes Commission's recommendations were designed to ensure greater accountability on the part of both the oil companies and the federal government:

> "If there is one concept that sums up the Commission's approach, it is accountability. Oil and gas companies must be held accountable for the obligations they undertake when they lease Federal and Indian lands for minerals production. The Federal government must be held

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> accountable for fulfilling a public trust, that is, assuring that royalties for the Nation's energy resources are fully and fairly collected on behalf of the people of the United States."

Id. at xvii. Moreover, in the context of mineral management on Indian lands, the Linowes Commission recognized that "the Federal government has a special responsibility as trustee for proper management of Indian natural resources." Id. at p. 6.

The Shoshone and Arapahoe Tribes are in agreement with the vast majority of the recommendations of the Linowes Commission and are pleased to see that many of these recommendations have been incorporated in S. 2305. The bill proposes numerous long overdue reforms: stiff civil and criminal sanctions for royalty accounting violations; a clear statutory requirement that anyone transporting oil on federal and Indian leases carry a run ticket; legal authority to stop trucks where there is probable cause to believe the driver does not have a run ticket; and provision for joint audit and inspection efforts between the Department of the Interior and Indian Tribes. The Shoshone and Arapahoe Tribes fully support these provisions and urge their prompt enactment.

The Tribes disagree strongly, however, with the proposal in section 20 of S. 2305 that would require royalty recipients to fund the royalty collection functions of the Department of the Interior. If enacted, section 20 would require all royalty recipients to contribute up to one percent of their royalties (after deduction of Windfall Profits Taxes) to a fund that would be used to finance the royalty management activities of the Department of the Interior. These activities are presently funded out of appropriations from general revenues.

In light of the Linowes Commission's conclusion that the royalty management system has been a failure for more than 20 years -- a finding entirely consistent with the results of the Tribes' own investigation -- the Tribes think it would be most inequitable to be required to pay for services that have been woefully inadequate for decades. As a result of the inadequacy of these services, the Tribes have already been required to devote significant tribal resources simply to correct years of government neglect. Although the investigation has recovered large sums of previously unpaid tribal royalties, there have been questions raised regarding the Tribes' ability to make themselves whole for other losses arising from government neglect. For example, tribal investigators discovered that one Wind River lease contains a clause providing for an equitable readjustment of the royalty rate every five years. Had this provision been exercised in timely fashion, the Tribes could have received as much as one million dollars in additional royalties. But the Department of the Interior, which has a fiduciary duty to the Tribes, never sought a royalty readjustment, and the oil company now argues that the readjustment cannot be made retroactively. Against the backdrop of problems of this sort, the Tribes think that it would most unfair to shift the funding obligation to royalty recipients.

To be sure, the Department of the Interior is now proposing changes in the royalty collection program, and the Tribes support efforts to revamp the program. But it remains to be seen whether the proposed changes will actually result in more effective royalty management. Until the promise of the new program is demonstrated, the Tribes have little choice but to commit tribal resources to keeping a careful eye on their lease accounts. Thus, if section 20 were enacted, the Tribes would be placed in the unenviable position of having to pay not only for the Department's royalty collection program on the Wind River Reservation, but also for tribal efforts to ensure that the Department is doing its job properly. This would scarcely be consistent with the Government's trust obligations to the Tribes.

Moreover, if section 20 were enacted, it most certainly should not be applied in a manner that would require the Tribes to contribute more to the royalty management fund than the Department spends in regard to Wind River lease accounts. A trustee should not exact a service fee in excess of that reasonably necessary to manage the beneficiary's assets.

In this regard, the Tribes object to the fact that, as now drafted, section 20 would require Indian lessors to contribute a greater percentage of their royalty income than that required to be contributed from federal leases. The contributions due under section 20, as now drafted, are based on a percentage of royalties after deduction of the Windfall Profits Tax. But, inasmuch as the Windfall Profits Tax is deducted only on federal leases but not on Indian leases, this would require Indian lessors to contribute a greater percentage of their royalty income than that required from federal leases. At a very minimum, if the Tribes are to be made to contribute to the royalty collection program, they should be placed on parity with the Federal Government.

In sum, the Shoshone and Arapahoe Tribes regard virtually all the proposed reforms of S. 2305 to be important steps on the road to prudent management of federal and Indian leases. But the Tribes strongly object to being asked to bear the costs for a royalty collection program that has been inadequate for years and for which the Tribes have had to make substantial expenditures to remedy.

Senator WALLOP. Thank you.

STATEMENT OF ED GABRIEL, FORMER DIRECTOR, COUNCIL OF ENERGY RESOURCE TRIBES; ACCOMPANIED BY JOHN BUTLER, SENIOR ECONOMIST, COUNCIL OF ENERGY RESOURCE TRIBES

Mr. GABRIEL. Mr. Chairman, I would like to thank you and the committee for inviting CERT to testify today on S. 2305 which would assure that the tribes do receive full compensation for their energy minerals.

Our testimony is divided into three major areas, and for the sake of time, I will summarize that.

The first section deals with our opposition, of course, to section 20, and hopefully will provide some thought process to other alternatives to have the fund pay for itself. Definitional and other questions that we have, with some time with your staff I think can be ironed out, and the third section deals with Indian involvement in the minerals program and suggestions on how we feel that part of the program could be implemented.

Let me begin by stating that we have testified before the Commission on Fiscal Accountability about these problems three times and have advocated greater internal controls, lease site security measures, and most importantly, an opportunity for the tribes to participate in royalty management which is virtually nonexistent in the past, as you well know.

As we stated before this committee in its January hearings on the Linowes Commission report, we believe that the Commission did an outstanding job of tackling the problems of royalty management which were ignored for so many years. We feel that if the Commission's recommendations to address these problems are carried out, they could finally get the Interior Department's program on track and insure that the public and Indian tribes receive the full revenues that are due them, and also I would like to commend

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Secretary Watt for giving the program such a high priority, beginning with the establishment of the Minerals Management Service separate from the USGS program. I might add CERT is currently working on the advisory program to help implement the Indian part to that.

As you know, S. 2305 is in close harmony with most of the Commission's recommendations. The bill provides for much needed requirements on lessees and mineral transporters, backed with adequate civil and criminal sanctions. Of key importance, it authorizes the Secretary to enter into those cooperative agreements with tribes to participate in the program. Those are points that we would like to underscore and say in our opinion are badly needed.

However, let me say that we are in opposition to section 20 of the bill which does require the Department, which requires that much of the Department's management program be financed by deducting up to 1 percent of the royalties collected for minerals produced on Federal and Indian lands.

When we appeared before this committee in January, we expressed our concerns over the Commission's recommendation that certain parts of the program be financed by imposing fees on Indian tribes. This was in fact the only one of more than 60 recommendations to which we objected, and unfortunately, we find that section 20 may even go further than the Commission's recommendation in assessing such charges.

The Linowes Commission recommended the establishment of a self-sustaining fund to support supplemental auditing and inspection programs. In making the recommendation, the Commission emphasized that this fund should not be used to pay for the basic royalty management program or as a device to avoid including a full complement of auditing and inspections in the basic continuing program. In spite of this, section 20 requires that the total amount of deductions taken from royalties collected on Federal and Indian lands be equal to the amount of funds appropriated for royalty management activities of the Department.

From the range of functions identified in section 20 which are highlighted, it is clear that the fee mechanism would be used to pay for the Department's basic program as well as the supplementary auditing and inspection programs.

We also want to point out that the Commission's principal rationale for establishing the self-sustaining fund was that it would provide a reliable and stable revenue source for supplemental activities, free of the uncertainties inherent in the annual appropriations process, yet the revenues collected under section 20 of the bill would be deposited in the U.S. Treasury as miscellaneous receipts, not into the fund earmarked specifically for royalty management functions, a point that was mentioned earlier.

Since the Federal Government's share of revenues collected from royalties for Federal leases are already deposited in the Treasury as miscellaneous receipts, this provision in our opinion does nothing to assure a reliable funding source. Mr. Chairman, what this does in our opinion is create a substantial burden on Indian tribes.

Now without spending a lot more time on this section, without lectures about how poor Indian tribes are, and as you well know, coming from Wyoming, the tribes do face some major economic problems even under the current budget cuts that are going on, we believe that the negative impact on the tribes far outweigh any savings of the Federal budget. We go into some figures.

For example, based on royalties for Indian oil and gas collected by USGS last year, the 1-percent deduction would have totaled $1.4 million. While we believe the Federal Government must take steps to reduce its budget and reduce its deficit, it must be acknowledged that the small addition to the Treasury would have a negligible impact on the objective, and the $1 million impact on the budget is probably not that much of an impact compared to what we would think would be over a hundred jobs that could be created with this $1.4 million if it were tribal income. Combine that with the current budget constraints and cuts, the policy of the current administration is to put in the hands of tribes their own private sector ability to develop for themselves less reliance on Federal assistance, and I think this is a step in the opposite direction. It is taking their one revenue source and making it, forcing them to obligate themselves to make up for budget deficits.

Second, there is a serious question of equity that I want to raise. The DOI, as trustee to the tribes has the responsibility to effectively protect the tribes' interests in Indian-owned resources held in trust. In regard to minerals management, it is clear that the Department, not the tribes, has failed over the years in carrying out that responsibility.

It is also clear that the companies operating on Indian lands have too often failed to carry out their responsibilities as lessees, yet we now see the financial burden of correcting the Department's problems being placed on the tribes through section 20.

Now we are not opposed to any recommendations that could come up with finding a way for the fund to pay for itself and reduce the Federal budget. Although we are opposed to anything that would impact the tribes, we would like to make a suggestion for an alternative for at least this committee to think about, and that would be assessing the overriding royalty on the lessees separate from the tribes' royalty, just a complete separate identified overriding royalty. From the perspective of the lessee, such a fee would be considered a normal cost of doing business. Most important, this concept would allow the marketplace to determine the distribution of the economic burden of the fee among the tribes, the lessees, and the consumers.

A portion of the fee would be passed on to the tribes through discounting bids on tribal leases. The remaining cost would be distributed among the lessees and consumers. The impact of the consumer, given last year's figures, would be two-tenths of 1 penny per gallon.

Let me just say in summary of our argument against section 20, we are talking about a trust responsibility of the Federal Government to account for these minerals, and we think the trust responsibility should stay there. You are talking about an economic impact that is unfair and inequitable to the tribes; $1.4 million means over a hundred jobs to tribes, yet you are talking two-tenths of 1 penny on the American consumer, so we graciously ask for your consideration of other alternatives if in fact you decide to move with some form of section 20.

Let me briefly summarize the second part of our testimony, the definitional questions we have. We would like to work with you and your staff to look at solutions to correct these. The first is regarding the applicability to alternative minerals agreements.

Under section 3(9) this could be construed to limit applicability of a bill only to the distribution of tribal minerals under conventional leasing. If new bills are moving through Congress, we would like to work with this committee to make sure that doesn't happen.

Second, applicability to split estates—the bill as currently drafted applies only to Indian lands and not to split estates where the Federal Government is holding only the minerals of tribes or allottees in trust. We would like to work with your staff on further definition of that.

Third, the scope of tribal cooperative agreements—section 18 authorizes the Secretary to enter into cooperative agreements with both States and tribes. There is different language under section 18(a) for States that differs as opposed to the language under 18(b) for tribes. We would just like to work with the staff to find out why, if there is a substantial reason to justify or correct that.

The last point we would like to make is regarding reporting by oil and gas purchasers. A key finding of the Commission on Fiscal Accountability was that reporting by oil and gas operators alone does not provide adequate safeguards to prevent accounting abuses. This is true since royalty data and production data come from the same company, and there is no way of independently cross-checking that information that is submitted.

One of the Commission's major recommendations to address this serious problem was to require reporting by purchasers of oil and gas produced on Federal and Indian lands. This is recommendation No. 7 of the Commission's report.

Now we believe that S. 2305 does make reference to this in section 8 by giving language. From what we have read, we are not very sure. We would like to work with the staff to make sure that there is this cross-checking intent in the legislation because we think it is a very important point that has to be brought out.

In closing, let me just reiterate our position that the key to effective royalty management on Indian lands is tribal participation and information-sharing among all parties, and we are pleased that you have considered this in S. 2305.

Let me just end on tribal participation by saying that we think it is in the tribes' vested interest to account for revenue coming to them. Let's give them a try because I think it is in their vested interest.

That ends my testimony, Senator, and I would be happy to answer questions. Thank you.

Senator **Wallop**. Mr. Butler, did you have testimony, too?

Mr. **Butler**. No, Mr. Chairman.

[The prepared statement of Mr. Gabriel follows:]

TESTIMONY OF

THE COUNCIL OF ENERGY RESOURCE TRIBES

BEFORE

THE SENATE COMMITTEE ON ENERGY AND
NATURAL RESOURCES

HEARING ON S.2305

May 3, 1982

Washington, D.C.

The Council of Energy Resource Tribes (CERT) appreciates the opportunity to present its comments on the Federal Energy and Mineral Resources Act of 1982, S.2305. CERT, a coalition of 34 American Indian tribes with substantial energy resources, is keenly aware of the failures of the Deparment of Interior's (DOI) royalty management program to assure that the tribes receive full compensation for their energy minerals. We have testified on three separate occassions before the Commission on Fiscal Accountability of the Nation's Energy Resources about these problems, and have advocated greater internal controls, lease-site security measures and — most importantly — an opportunity for the tribes to participate in royalty management, which was virtually non-existent in the past.

As we stated before this Committee in its January hearings on the Linowes Commission report, we believe that the Commission did an outstanding job of tackling head-on the problems of royalty management which have been ignored for so many years. We feel that if the Commission's recommendations to address these problems are carried out, they could finally get the Interior Department's program on track and insure that the public and Indian tribes receive the full revenues that are due them. We are very pleased with the priority which Secretary Watt has given to restructuring the program, beginning with the establishment of the Minerals Mangement Service completely separate from the U.S. Geological Survey (USGS). CERT is currently participating on the Service's advisory group to assist in the development of procedures and policies implementing these recommendations as they pertain to tribal lands.

We believe that S.2305 is in close harmony with most of the Commission's recommendations. The bill provides for much-needed requirements on lessees and mineral transporters, backed with adequate civil and criminal sanctions. Of key importance, it authorizes the Secretary of Interior to enter into cooperative agreements with Indian tribes to participate in royalty management responsibilities.

However, we must express our strong opposition to Section 20 of the bill, which requires that much of the Department's royalty management program be financed by deducting up to one percent of the royalties collected for minerals produced on federal and Indian lands. When we appeared before this Committee in January, we expressed our concerns over the Linowes Commission's recommendation that certain parts of the royalty management program be financed by imposing fees on Indian tribes. This was, in fact, the only one of the Commission's sixty recommendations to which we objected. Unfortunately, we find that Section 20 goes even farther than the Commission's recommendation in assessing such charges on the tribes.

The Linowes Commission recommended the establishment of a self-sustaining fund to support supplemental auditing and inspection programs. In making this recommendation, the Commission emphasized that this fund should not be used to pay for the basic DOI royalty management program, or as a device to avoid including a full complement of auditing and inspections in the basic, continuing program (Commission Report, page 132). In spite of this, Section 20 requires that the total amount of deductions taken from royalties collected on federal and Indian lands be equal to the amount of funds appropriated for royalty management activities of the Department. From the range of functions identified in Section 20 as "royalty management activities" (i.e., accounting, auditing, production valuation, data collection, regulation writing, enforcement and engineering technical support, it is clear that the fee mechanism would be used to pay for the Department's basic program as well as for supplementary auditing and inspection programs.

We must also point out that the Linowes Commission's principal rationale for establishing a self-sustaining fund was that it would provide a reliable and stable revenue source for supplemental activities, free of the uncertainties inherent in the annual appropriations process. Yet, the revenues collected under Section 20 of this bill would be deposited in the U.S. Treasury as miscellaneous receipts, not into a fund earmarked specifically for royalty management functions. Since the federal government's share of revenues collected from royalties for federal leases are already deposited in the Treasury as miscellaneous receipts of royalty management funding, this provision does nothing new to assure a reliable funding source. What it does do is to place a substantial burden on Indian tribes.

Why do we object so strongly to deducting from tribal royalties? First, we believe that the negative impact on the tribes would far outweigh any savings to the federal budget. For example, based on royalties for Indian oil and gas collected by the USGS last year, the one percent deduction would have totalled about $1.4 million. While we believe that the federal government must take steps to reduce its budget deficit, it must be acknowledged that this small addition to the Treasury would have a negligible impact on this objective. Yet, given the current budget constraints of tribal governments, at the individual tribal level there could be a major impact, which could mean the difference between a tribe having its own minerals management program or not having it. The recent cuts in federal assistance programs to tribal governments have made it extremely difficult for them to deliver basic human services, let alone conducting adequate natural resource management responsibilities.

Secondly, we believe that there is a serious question of equity raised by Section 20. The DOI as trustee to the tribes has the responsibility to effectively protect the tribes' interests in Indian-owned resources held in trust. In regard to minerals management, it is clear that the Department -- not the tribes -- has failed over the years in carrying out this responsibility. It is also clear that companies operating on Indian lands have all too often failed to carry out their responsibilities as lessees. Yet, we now see the financial burden of correcting the Department's and lessees' failures being placed on the Indian tribes by the requirements of Section 20.

We are not opposed to the concept of the program paying its own way but believe that there is a far more equitable way to do this that would not pass the entire burden on to the tribes. This would be to assess the fee on the lessees instead of the tribes. From the perspective of the lessee, such a fee would be considered a normal cost of doing business on federal and Indian lands. This concept would allow the marketplace to determine the distribution of economic burden of the fee among the tribes, the lessees and the consumers. A portion of the fee would be passed on to the tribes through discounted bids on tribal leases. The remaining costs would be distributed among the lessees and resource consumers. The costs to the consumer would at most be one-tenth of a cent per gallon for refined products from oil produced on federal and Indian lands at today's petroleum prices. But in reality the consumers' share would generally be much less than this. We urge the Committee to give serious consideration to this or to other alternatives to that embodied in Section 20.

In addition to our major concern over Section 20, we would offer the following comments on S.2305:

- Applicability to Alternative Minerals Agreements: The definition of "mineral leasing law" at Section 3(9) could be construed to limit the applicability of this bill only to the disposition of tribal minerals under the conventional leasing arrangements pursuant to the Indian Minerals Leasing Act of 1938. Tribes today are negotiating minerals agreements which are not leases as addressed in the 1938 Act, such as joint ventures and production sharing agreements. There is currently a bill pending in Congress, S.1894, that would give the Secretary of Interior authority to approve such tribally negotiated minerals agreements outside of the narrowly drawn authority of the 1938 Act. To assure that tribal agreements approved under authorities other than the 1938 Act are addressed in S.2305, it is recommended that the phrase "under lease" in Sections 3(9) and 3(10) be deleted.

- Applicability to Split Estates: The bill as currently drafted applies only to Indian lands, and not to split estates where the federal government is holding only the minerals of tribes or allottees in trust. To remedy this situation, the definition of "Indian allottee" (Section 3(2)), "Indian lands" (Section 3(3)) and "Indian tribe (Section 3(4)) be revised to read "land or minerals held in trust by the United States."

- Scope of Tribal Cooperative Agreements: Section 18 authorizes the Secretary to enter into cooperative agreements with states and Indian tribes to carry out royalty management functions. We believe that this opportunity for active participation by the tribes is essential to the development of an effective program. We wish to point out, however, that the language of Section 18(a) regarding the authority of the Secretary to approve state cooperative agreements differs somewhat from that of Section 18(b) which addresses tribal cooperative agreements. Specifically, Section 18(a) authorizes the Secretary to enter into cooperative agreements with states to ". . . carry out inspection and auditing activities in cooperation with, and under delegated authorities from, the Department, and to carry out any other activity described in Subsections (b), (c), and (d) of Section 6 of this Act." The analogous phrase in Section 18(b) states simply ". . . to carry out certain inspection and auditing activities . . ." with no specific reference to individual sections of the Act. We are not clear what, if any, substantive difference this alternate language would make, but respectfully request the Committee to examine this question in order to assure that the opportunity for tribal participation is not diminished.

- Reporting By Oil and Gas Purchasers: A key finding of the Commission on Fiscal Accountability of the Nation's Energy Resources was that reporting by oil and gas operators alone does not provide adequate safeguards against accounting abuses. This is true since both royalty data and production data comes from the same company, and there is no way of independently cross-checking the information that is submitted. One of the Commission's major recommendations to address this very serious problem was to require reporting by purchasers of oil and gas produced on federal and Indian lands. This is Recommendation Number 7 of the Commission's final report:

  > "7. That the Department seek legislation authorizing the federal royalty managers to require that purchasers submit copies of their reports directly to the federal royalty managers in a format prescribed by the royalty managers, and to impose civil penalties in the event of noncompliance. This authority would be exercised at least in those cases where there is no other government-required report provided by a party different from the payor covering that particular oil, gas, or other mineral taken from the lease for the same reporting period; and
  >
  > That the federal royalty managers systematically check these purchaser reports against reports submitted by the payor, at least on a sample basis."

  We believe that S.2305 should incorporate this critical requirement.

In closing, we would like to reiterate our position that the key to effective royalty management on Indian lands is tribal participation and information sharing. We are pleased that S.2305 includes such opportunities for the tribes.

Although there are certain elements of royalty management that are transferrable to all tribes, we do not believe that a single rigid approach is applicable to all reservation situations. Therefore, we believe that before proceeding on a major scale to issue cooperative agreements, DOI should establish demonstration programs on a selected number of reservations to determine how its program can best mesh with individual tribal programs. After the first year of such demonstrations the Department would have enough diversity of experience to provide a sound basis for developing a longer-term program that would most effectively combine individual tribal capabilities with its own. We urge the Committee to include in its report on S.2305 direction to the Secretary to initiate such a demonstration process as soon as possible.

Thank you for this opportunity to provide our views on this important bill. We would now be pleased to answer questions that you may have.

Senator **Wallop**. Well, you have made some interesting points. The split estate problem is one reason why it is probably difficult to deal with the assessment of a percent or one-half of 1 percent, and it still seems to me, at least, that the overriding benefit for any tribe is far greater to have the new accounting system and the new, more efficient collection than it is to talk to the $1 million. To pay $1 million to get an additional $7 million seems better than not to pay the $1 million and keep the status quo, just as a matter of one hand rubbing the other.

It always seems to be there is some benefit to be collected. We will pay attention to what you say and see what we can do with it. I guess I am concerned as to how, and I appreciate recommendations, people's recommendations that Indian tribes ought to share in any interest penalties, but not if they are not interested in sharing in all of the accounting that gets them those penalties. It just seems to me there is a balance, an equity situation.

The Indian people I know, I don't know any who don't want to carry their fair share of things, and I am a little concerned that maybe this doesn't represent them as specifically or, I don't mean to say directly, but I know the Arapahoe and Shoshone are not that sort of people. They would be willing to pay their fair share in order to get their fair share.

Mr. **Goodman**. They are paying their fair share except they are having to pay it to private parties.

Senator **Wallop**. At the moment, but that same situation holds true of the State of Wyoming or anybody else that is involved in the same kind of thing, and it goes on from there, and I am not interested in assessing blame for what has gone on. I am talking about where we go from here and the assessment of an overriding royalty might be a good idea from this day forward or the day past forward on any new leases, but you can't go establish an overriding royalty on an old lease because you have a contractual arrangement that exists, but I don't think—we can probably tinker with that, but we will try to work that out. I appreciate your coming.

Mr. **Gabriel**. Thank you, Senator.

Senator WALLOP. Before I call on the next witness, Mr. Charles Mankin, State geologist of Oklahoma, who is representing the American Institute of Professional Geologists. I would like to put in the record a letter and some commentary by former Governor Hathaway. The letter is to me with some comments on S. 2305, and he brings out some problems especially with regard to section 12 which I think ought to be in the record.

Good morning: I still have 30 seconds to say good morning. After that, it is good afternoon.

[The letter follows:]

HATHAWAY, SPEIGHT AND KUNZ
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ATTORNEYS AT LAW
ONE PIONEER CENTER
2424 PIONEER AVENUE
CHEYENNE, WYOMING 82001

STANLEY K. HATHAWAY
JOHN B. "JACK" SPEIGHT
BRENT R. KUNZ
BLAIR J. TRAUTWEIN
RICHARD J. BARRETT

TELEPHONE
AREA CODE 307
634-7723

1982 APR 27 AM 3:57

April 23, 1982

The Honorable Malcolm Wallop
United States Senator
452 Russell Building
Washington, D. C. 20510

Dear Malcolm:

I understand that you will soon be holding hearings on S.2305 in the Senate Energy Committee. I have looked at this bill and generally agree with its thrust to give better accountability in the collection of royalties. I assume that it is sponsored by the Interior Department and somewhat based on the recommendations of the Linowes Commission.

The purpose of this letter is to call your special attention to Section 12 of the bill. This section is totally out of harmony with the rest of the bill and is designed to attempt to absolve the Interior Department from liability for violations of the mandatory petroleum price regulations of the Department of Energy. There is absolutely no reason to give the Interior Department such immunity.

I wanted you to know further that this problem directly involves the Wyoming Refining Company refinery at Newcastle, Wyoming, which has a suit pending against the Interior Department to recover excessive prices charged by the Interior Department for crude oil over the past several years. The amount involved is well over $1 million. As you know, small refineries have been having a very difficult time economically, and the recovery of this money is vital to the Wyoming Refinery at Newcastle. I am enclosing herewith a synopsis which outlines the objections of Wyoming Refining Company to Section 12 of S.2305. Anything you can do to eliminate Section 12 from the bill or to amend it so that it is not in any way retroactive upon existing claims, will be greatly appreciated. Please advise if I may furnish further information in regard to Wyoming Refining Company's problem. I will be glad to visit with you or members of your staff on the telephone. I had hoped to see you at your reception in Cheyenne on Monday, but I am afraid a doctor's appointment is going to prevent me from doing so.

With warm regards, I am

Sincerely,

Stan Hathaway

SH:br

Enclosure

SECTION 12 OF S.2305

INTRODUCTION

One of the largest producers of crude oil in the United States is the Department of Interior ("DOI"). Through its Minerals Management Service (and previously through the U.S. Geological Survey, "USGS") the DOI administers interests in vast oil and gas properties owned by the United States onshore and on the Outer Continental Shelf. In 1981 alone the DOI collected over 4 billion dollars in royalties on oil and gas. From 1974 until January 28. 1981, when price controls were removed by the President, DOI was subject to the Mandatory Petroleum Price Regulations promulgated by the Department of Energy ("DOE") and its predecessors, the Federal Energy Office ("FEO") and the Federal Energy Administration ("FEA"). In a number of instances DOI charged prices for crude oil that were unlawfully high under DOE's regulations. These overcharges were collected principally from small refiners whose size and need for crude oil left them with no choice but to yield to DOI's demands for unlawful prices.

Irregularities in DOI's management of the federal royalty oil program were the subject of an extensive investigation recently conducted by the Commission on Fiscal Accountability of the Nation's Energy Resources (commonly referred to as the "Linowes Commission"). In January 1982 the Commission released a detailed report, Fiscal Accountability of the Nation's Energy Resources, which outlined 60 recommendations by the Commission for creating an effective federal royalty management system. Ostensibly in furtherance of that report, DOI drafted S.2305, "The Federal Energy and Mineral Resources Act of 1982." Hidden within S.2305 is section 12, entitled "Secretary's Independent Authority to Collect Royalty." This section would grant the DOI absolute immunity from any liability for violations of the DOE Mandatory Petroleum Price Regulations.[1]

Section 12 is not based in whole or part on any of the recommendations of the Linowes Commission. Nor does section 12 have anything to do with DOI's continued authority to collect royalties. DOE's price regulations were removed on January 28, 1981,[2] and the authority of DOE to promulgate any new petroleum price regulations expired in October of 1981.[3] Instead, section 12 is an attempt by DOI to obtain Congressional immunity from actions against it for past overcharges in the sale of crude oil. The enactment of such a provision not only has serious constitutional implications but also would poorly serve the public interest by arbitrarily exempting one of the largest producers of crude oil from price regulations which this Administration has consistently told Congress it will rigorously enforce with no amnesty for overchargers.

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[1] The purposes of the Act set forth in section 2 give no hint that Congress is being asked to grant DOI immunity from its past illegal conduct.

[2] Executive Order No. 12287, 46 Fed. Reg. 9909 (January 30, 1981).

[3] Section 18 of the Emergency Petroleum Allocation Act of 1973, as amended, 15 U.S.C. § 760g.

DISCUSSION

To put section 12 in proper perspective, some appreciation of the history of DOI's regulation by DOE and of DOI's attempts to avoid compliance with those regulations is appropriate. When mandatory controls on the prices of crude oil were instituted in August of 1973, as part of Phase IV of the Economic Stabilization Act, the prices charged by federal, state and local governments were exempted.[4]

In 1973 Congress enacted the Emergency Petroleum Allocation Act, Public Law 93-159 ("EPAA"). Section 4(a) of the EPAA[5] authorized the President to promulgate regulations providing for the mandatory allocation and pricing of crude oil, with no exception stated for crude oil produced and sold by the federal government. To the maximum extent practicable, regulations promulgated by the President pursuant to such authority were to provide for the "preservation of an economically sound and competitive petroleum industry . . . and to preserve the competitive viability of independent refiners [and] small refiners, . . ." and for the "equitable distribution of crude oil . . . at equitable prices among all . . . sectors of the petroleum industry, including independent refiners [and] small refiners . . . ."[6]

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[4] 6 C.F.R. § 150.54, 38 Fed. Reg. 21,601-02 (August 9, 1973).

[5] 15 U.S.C. § 753(a).

After enactment of the EPAA the exemption for prices charged by governments was initially continued in similar regulations adopted by the Federal Energy Office.[7] On April 2, 1974, this exemption was removed, however.[8] After April 4, 1974, the Mandatory Petroleum Price Regulations[9] of the FEA and the DOE, expressly provided that "[t]he prices charged for any sale of a covered product by any Federal department, agency or other instrumentality . . . are subject to the price regulations of this part . . . ."[10]

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[6] Section 4(b) of the EPAA, 15 U.S.C. § 753(b)(1)(D) and (F).

[7] 39 Fed. Reg. 1924, 1952 (January 15, 1974).

[8] 39 Fed. Reg. 12,252-55 (April 4, 1974). One of the reasons cited by FEO for removing this exemption was "to preserve the competitive viability of small and independent refiners" by protecting them from "substantially higher prices . . . obtainable for uncontrolled crude oil." Id. at 12,253.

[9] The regulations were codified as 10 C.F.R. Part 212.

[10] 10 C.F.R. § 212.52

The applicability of the Mandatory Petroleum Price Regulations to the federal government, including DOI, was repeatedly stated in public pronouncements of the DOE and its predecessors and was affirmed by the Temporary Emergency Court of Appeals. In 1975 the FEA issued a formal interpretation to the Navy stating that "the Mandatory Petroleum Price Regulations apply uniformly to Federal, State, and local governments."[11/] The same year, the Temporary Emergency Court of Appeals held that FEA had the statutory authority to regulate the sale of crude oil by federal agencies.[12/]

Soon after the Mandatory Petroleum Price Regulations were made applicable to sales by the federal government, FEA issued a formal ruling to the Department of Interior stating that FEA's Mandatory Petroleum Allocation Regulations applied to sales of crude oil by the Department of Interior.[13/]

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[11] Interpretation No. 75-15; CCH Compliance Manual ¶ 52,256, at page 56,281 (March 20, 1975).

[12] Mohawk Petroleum Corp. v. Department of the Navy, 521 F.2d 1394 (TECA 1975). As a result of Mohawk Petroleum and Interpretation 75-15, the Navy sought and obtained statutory exemption from FEA's regulatory scheme. Section 103(b) of the Naval Petroleum Reserves Production Act of 1976, Public Law 94-258, April 5, 1976, 10 U.S.C. § 7430(b). This exemption for naval reserve petroleum oil was subsequently carried forward into FEA's regulations in the form of 10 C.F.R. § 212.55 and § 212.131(a)(5)(iv). Neither Congress nor the FEA provided a similar exemption to the Department of Interior, however.

[13] Ruling 1974-22, 3 CCH Energy Management ¶ 16,032 (July 9, 1974).

Later that year DOI's Casper, Wyoming, regional office sought confirmation from the Chief of the USGS Conservation Division that FEA's Mandatory Petroleum Price Regulations applied to USGS as a seller of royalty oil.[14] In May of 1975 the Chief of the USGS Conservation Division formally concluded that as a seller of royalty oil, DOI was subject to FEA's regulations.[15] In a later decision and order issued to USGS, FEA expressly held that its Mandatory Petroleum Price Regulations were applicable to USGS and superseded any conflicting regulations of USGS.[16]

Subsequently, Congress itself removed any doubt about DOE's authority to regulate the prices charged by DOI for federal royalty oil. In the Department of Energy Organization Act,[17] Congress transferred from the Secretary of Interior to the Secretary of Energy the authority to promulgate regulations governing the procedures, terms and conditions for acquisition and disposition of federal royalty oil taken in kind.[18] The following year, when Congress enacted the Outer Continental Shelf Lands Act Amendment of 1978,[19] it specifically provided that the Secretary of Interior's authority to dispose of federal royalty oil must be in accordance with price regulations promulgated by the Secretary of Energy.[20]

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[14] Appendix 1.

[15] Appendix 2.

[16] United States Geological Survey, 5 FEA ¶ 80,537 (January 26, 1977).

[17] Public Law 95-91, August 4, 1977.

[18] Section 302(b) of the Department of Energy Organization Act; 42 U.S.C. § 7152(b).

The fact that DOI has been subject to the Mandatory Petroleum Price Regulation since 1974, has not, however, meant that DOI has complied with those regulations. For example, the May 1975 memorandum from the Chief of the USGS Conservation Division,[21] while acknowledging that USGS was bound by FEA's price regulations, also advised lower-level USGS officials not to comply with those regulations.[22]

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[19] Public Law 95-372, September 18, 1978.

[20] Section 208 of the Outer Continental Shelf Lands Act Amendment of 1978; 43 U.S.C. § 1353(b)(1) and (3).

[21] Appendix 2.

[22] Following the initial statement of applicability the Chief of the Conservation Division outlined the procedures that USGS would apply. The Chief of the Conservation Division then stated: "We realize that this procedure of estimating old and new oil does not accurately reflect the old and new volumes . . . and will not meet the FEA's deadline." The Chief then went on to state the method for correctly complying with FEA's regulations. The Chief of the Conservation Division concluded, however, that the correct method would not be used. "[W]e do not intend to use this procedure unless it is required at a later date because of the additional workload involved and the fact that no internal benefits result from either procedure."

Although it used additional workload as an excuse for not complying with the law, DOI subsequently obtained authority, unavailable to private producers, to charge an additional 1/2% of the price of each barrel of oil sold to compensate it for this additional workload. 10 C.F.R. § 212.74(d); 45 Fed. Reg. 9526, 9534 (February 12, 1980).

Efforts by DOE to obtain DOI's voluntary compliance with DOE's price regulations were of no avail. Through the very end of price controls DOI refused to adhere to DOE's regulations in the face of repeated warnings by DOE and requests from small refiners that purchased royalty oil from DOI.[23]

CONCLUSION

By eliminating retroactively all DOI accountability for past overcharges, section 12 may well violate the just compensation clause of the Fifth Amendment. As an *ex post facto* interference with vested contract rights section 12 probably also violates the due process clause of the Fifth Amendment. Many of DOI's royalty oil contracts were specifically subject to prices allowed by DOE. All of DOI's contracts were generally subject to emergency statutes such as the EPAA. Furthermore, by attempting to immunize DOI from overcharge actions, while leaving private producers of crude oil still subject to such actions, section 12 raises serious equal protection problems, not to mention the inherent unfairness of such a selective enforcement scheme.

From a public policy standpoint, the enactment of a statute such as section 12 is also extremely unwise. Allowing an agency which for years has knowingly flaunted regulations applicable to it to come in after the fact and obtain congressional absolution would serve as a precedent that would make DOI and other agencies less vigilant in their adherence to laws applicable to them. In addition, granting immunity to DOI would be contrary to Congress' expressed policy that regulations promulgated under the EPAA protect the interests of small and independent refiners. Denying refiners who purchased oil from DOI the remedies available to them against DOI for violating DOE's regulations would obviously run counter to that policy. Finally, section 12 flies in the face of the announced purpose of the Federal Energy and Mineral Resources Act of 1982, and of the recommendations of the Linowes Commission, both of which were intended to correct DOI's prior mismanagement in administering the federal royalty oil program and to insure major improvements in the program. Granting immunity for past mismanagement is certainly an inauspicious means of insuring lawful, efficient management of the royalty oil program in the future.

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[23] See attached DOE memos dated October 1 and 18, 1979, and attached letter of October 25, 1979, from DOE to DOI. (Appendices 3, 4, and 5.)

United States Department of the Interior
GEOLOGICAL SURVEY
P.O. BOX 2859
CASPER, WYOMING 82601

IN REPLY REFER TO:
81-CA

December 23, 1974

Memorandum

To: Chief, Conservation Division
Attention: Mr. Wyatt

Through: Conservation Manager, Central Region

From: Oil and Gas Supervisor, Northern Rocky Mountain Area

Subject: Applicability of FEA regulations to USGS as a "seller" of royalty oil

Enclosed is a copy of Part IV of the Federal Register dated December 14, 1974. The new requirements contained in section 212.131 raise several questions because of our oil sales under royalty oil contracts.

Question No. 1 is whether the U. S. Government and, specifically, this office is considered under these regulations as "a seller of domestic crude petroleum, other than a producer" mentioned in section 212.131(a)(2). If so, this would make our office subject to the requirement, mentioned in the same section, to provide the purchaser of crude petroleum written certification of the amounts of old and new oil included in a sale. If this regulation does apply to the Government as a seller of crude oil, the following questions are posed.

One question involves the amount of time, after the month of sale, that a seller is allowed for furnishing certification. Section 212.131(b) indicates that written certification should be made within 25 days following the month crude oil is delivered. This 25-day time limit is inserted immediately after the requirements associated with an allocation sale. Should this be construed so that the 25-day time limit is applicable only to allocation sales, or does this limit also apply to other sellers mentioned in section 212.131, as a whole, including our office?

If this 25-day time limit applies to our royalty oil sales, we are in doubt about our ability to comply with the new requirements of section 212.131. If the time limit does not apply to the certification requirements for royalty oil sales, we would appreciate clarification of the time frame that will apply to this office. In light of our present reporting requirements and accounting procedures, our office could not accurately certify the volumes of old and new oil sold to a refiner any sooner than 60 days after the end of the month of sale, and then we could certify only as to the volumes of old and new oil that should have been delivered to our purchaser. We have not made it our business to inquire into any "over and short" accounts which may be kept between the lease operator and the royalty oil purchaser although we are certain that, at least in some cases, those accounts exist.

It is true, that under normal conditions, many lessees report to us on form 9-361, 100 percent of sales, for a particular month, by the 25th day of the month following the month of sale. It is also true, however, that some lease operators producing oil, which we take in kind, do not report until after the first of the second month following the month of sale. This is true even though such late reporting usually subjects the operator to a $10 assessment for liquidated damages.

In order to certify what amounts are old and new oil, we must know our royalty interest in the 100 percent volume sold. It is not possible to determine our royalty interest in the oil at the time the lessees' reports are received unless we manually compute royalty interest for each report. The volume of reports received by this office related to royalty oil is large. Computation of royalty interest manually on leases providing royalty oil would not be practicable because of the time required to make calculations. In addition, this approach would defeat the advantages of being computerized since the computer calculates royalty interest in the course of our normal processing.

The time lapse between receiving lessees' reports, processing by the computer, and a return of output to us reflecting our royalty interest is approximately one month. when the computer listing is received by our office, we can then determine our royalty oil interest and provide a certification of the amount of old and new oil for that particular month by using the computer printout in conjunction with the old and new oil information shown on our 9-361 reports. Since there is no way to enter old oil and new oil in the computer so that it will be reported and identified as old and new, at best, any required certification will be a time-consuming process.

In summary, reports from lessees reporting royalty oil are received about one month after the month of sale. Another month is required for processing of the reports to a usable form. Since the whole process takes approximately 60 days after the month of sale, if the new requirement for certification of old and new oil calls for compliance within a shorter period of time than 60 days after the month of sale, our office would be in continuous violation of section 212.131.

Would you please provide our office with clarification, at your earliest convenience, of the effect of section 212.131 on our royalty oil activities? If our office is subject to a time limit for certification which we can not meet, would you please comment on the effect of this violation on our existing royalty oil contracts.

C. J. Curtis

C. J. Curtis

Enclosure

Memorandum

To: Area Oil and Gas Supervisor, Northern Rocky Mountain Area
Through: Conservation Manager, Central Region

From: Chief, Conservation Division

Subject: Applicability of FEA regulations (10 CFR 212.131) to USGS as a "seller" of royalty oil

In answer to your memorandums of December 23, 1974, and April 25, 1975, we have reviewed 212.131 of Part IV of the Federal Register dated December 14, 1974, and have had discussions with FEA representatives. Based on this review, we have concluded that under these regulations the USGS should be considered as a seller of oil.

The following procedures should be put into effect immediately by all Area Oil and Gas offices having royalty oil contracts:

A. For a given month, establish the average price paid for old and new crude oil sold in the area. For each royalty oil contract, divide the royalty value by the royalty quantity to determine the average price paid for the oil taken that month. The contract royalty value and royalty quantity are shown in the ADP printout "ROYALTY TAKEN IN KIND."

If we use Casper's "RIK CODE 18 CONTRACT" for the month of February 1975 and assume average area prices of $5.35/bbl. and $10.15/bbl. for old and new oil, respectively, we may use the royalty quantity of 78,923.85 barrels and the royalty value of $544,490.71 to make the following calculations:

1. $\frac{\$544{,}490.71}{78{,}923.85} = \$6.8989/\text{bbl.}$

If the average price calculated is $5.35 per barrel or less, then all the oil for this contract may be considered as old oil, and no further calculation is needed.

Appendix 2

2. Let x = percent of old oil $\quad x + y = 1$
Let y = percent of new oil $\quad y = 1 - x$
then,

$$5.35x + 10.15y = 6.8989$$
$$5.35x + 10.15(1 - x) = 6.8989$$
$$5.35x + 10.15 - 10.15x = 6.8989$$
$$-4.80x = -3.2511$$
$$x = .6773 \text{ or } 67.73\%$$
$$y = 1 - x \text{ or } 1 - .6773 = .3227 \text{ or } 32.27\%$$

Thus, old oil sold under the contract for the month is $78,923.85 \times .6773 = 53,455.12$ barrels, and new oil sold amounts to $78,923.85 \times .3227 = 25,468.73$ barrels.

3. Enclosed are EXHIBIT A, showing how the above would be reported on a monthly form, and EXHIBIT A1, showing the ADP "ROYALTY TAKEN IN KIND" printout for RIK 18. Also, enclosed are a few of the blank forms entitled "REPORT ON OLD, NEW, RELEASED AND STRIPPER WELL OIL" that may be reproduced and used in reporting each month to the royalty oil purchasers.

We realize that this procedure of estimating old and new oil does not accurately reflect the old and new oil volumes because of the correction of earlier charges and variations in oil pricing. In addition, this new report will be filed after receipt of the ADP printouts of "ROYALTY TAKEN IN KIND" and will not meet the FEA's deadline. The only other practical procedure for reporting old and new oil would be to separate the input for old and new oil by using an ADP source code for the new oil. For example, source code 365 shown on the enclosed EXHIBIT A1 could be N65 for new oil, and the regular source code could be maintained for old oil. However, we do not intend to use this procedure unless it is required at a later date because of the additional workload involved and the fact that no internal benefits result from either procedure.

Chief, Conservation Division

Enclosures

cc: RCM - Denver
Menlo Park
Metairie
Washington, D. C.

Area Oil and Gas Supervisors
Los Angeles
Metairie
Roswell
Tulsa
Anchorage
Washington, D. C.

CS&D - Denver
CD - Royalty oil contract file (onshore general)
✓ Harris
Ewyatt:WMHarris:05/08/75

EXHIBIT M

United States Department of the Interior
GEOLOGICAL SURVEY
P.O. BOX 2859
CASPER, WYOMING 82601

REPORT ON OLD, NEW, RELEASED AND STRIPPER WELL OIL

LAKETON ASPHALT
REFINING, INC.
P. O. BOX 3525
EVANSVILLE, IND. 47734
(ROYALTY OIL PURCHASER)

DATE MAY 6, 1975
CONTRACT NO. 14-08-0001-13750
FOR MONTH/YEAR FEB., 1975

GENTLEMEN:

THIS REPORT IS MADE TO YOU AS PURCHASER OF ROYALTY OIL FROM THE ABOVE CONTRACT NUMBER FOR THE MONTH AND YEAR SHOWN IN ORDER FOR YOU TO COMPLY WITH FEA REQUIREMENTS.

ACCORDING TO OUR RECORDS YOU PURCHASED THE FOLLOWING:

	TOTAL VOLUME (BARRELS)	WEIGHTED AVERAGE COST PER BARREL	TOTAL COST
NEW, RELEASED AND STRIPPER WELL	25,468.73	10.15	258,507.61
TOTAL OLD OIL	53,455.12	5.35	285,983.10
GRAND TOTAL OIL	78,923.85	6.90	544,490.71

ROBERT C. GETTYS
FOR (AREA OIL & GAS SUPERVISOR)

United States Department of the Interior
GEOLOGICAL SURVEY

REPORT ON OLD, NEW, RELEASED AND STRIPPER WELL OIL

DATE________________
CONTRACT NO. 14-08-0001-_____
FOR MONTH/YEAR____________

____
____
____
(ROYALTY OIL PURCHASER)

GENTLEMEN:

THIS REPORT IS MADE TO YOU AS PURCHASER OF ROYALTY OIL FROM THE ABOVE CONTRACT NUMBER FOR THE MONTH AND YEAR SHOWN IN ORDER FOR YOU TO COMPLY WITH FEA REQUIREMENTS.

ACCORDING TO OUR RECORDS YOU PURCHASED THE FOLLOWING:

	TOTAL VOLUME (BARRELS)	WEIGHTED AVERAGE COST PER BARREL	TOTAL COST
NEW, RELEASED AND STRIPPER WELL			
TOTAL OLD OIL			
GRAND TOTAL OIL			

____
(AREA OIL & GAS SUPERVISOR)

Department of Energy
Washington, D.C. 20461

OCT 1 1979

MEMORANDUM FOR BARTON ISENBERG
ASSISTANT ADMINISTRATOR FOR ENFORCEMENT
ECONOMIC REGULATORY ADMINISTRATION

FROM: ROBERT D. GERRING
DIRECTOR FOR PROGRAM OPERATIONS
OFFICE OF ENFORCEMENT

SUBJECT: U.S. GEOLOGICAL SURVEY

A great deal of rhetoric has transpired regarding whether the crude producer regulations should be enforced with regards to sales by the U.S. Geological Survey.

On the surface, it is a case of whether or not the Department of Energy (DOE) should extract refunds from another government agency when, ultimately, at least a portion of the refunds may remain in a government account. The situation is more serious and complex than the above statement. The specific question is this: "Is the U.S. Geological Survey exempt from duly authorized laws, whereby it can sell its crude oil at any price it desires, or must it abide by the regulations as set forth by other Federal agencies?"

According to information supplied by L.K. Jones, the Survey does not operate any of its own leases. Rather, it receives royalties in kind from the lease operators, which it sells on its own accord. As the crude oil is produced from Federally-owned land, no other royalties are paid. In the past, it has been alleged that crude oil has been sold in excess of maximum legal ceiling prices.

Furthermore, in most cases, it has refused to provide certifications concerning the correct tier of oil it is selling. The policy of challenging the Department of Energy's authority to regulate energy by governments, i.e. Federal, State, and city, is becoming more prevalent. Recently, the States of Wyoming and Louisiana have questioned the authority of the supplier/purchaser rule and have directed that oil produced in those States will remain in those States. In addition, relationships have been terminated unilaterally.

It is my belief that we should meet with the U.S. Geological Survey to discuss all aspects of the case and propose that compliance with the regulations on a current basis take place. If we do not receive cooperation from the Survey, we should take appropriate action to recover overcharges and establish compliance with current regulations.

Tom Holleran, Wayne Tucker, and myself are available to discuss the matter with you.

cc: W Tucker
    T Holleran

Department of Energy
P.O. Box 35228
2626 W. Mockingbird Lane
Dallas, Tx. 75235

13 OCT 1979

SUBJECT: U. S. Geological Survey

FROM: Wayne I. Tucker, District Manager
Southwest District Enforcement

TO: Barton Isenberg, Assistant Administrator
for Enforcement
Economic Regulatory Administration
Washington, D.C. 20461

We were delighted to receive your FAX message of October 1, 1979 indicating your reconsideration of the question of whether USGS is subject to the DOE's Mandatory Pricing Regulations as well as other federal agencies, states and cities. We believe very strongly that they are subject to DOE's regulations as are all entities that produce, sell or refine or have someone produce sell or refine covered products for their account. We have had numerous complaints from the oil industry against USGS. The following describes some of their complaints as well as the actions we have taken and is provided to assist in your final deliberations of the scope and magnitude of this problem. We wholeheartedly support enforcement of DOE's regulations fairly and equally against all public or private entities whose products are subject to the Mandatory Pricing Regulations.

In early 1977 we conducted an audit of the records of the United States Geological Survey (USGS). This audit focused on sales of crude oil by USGS Gulf Coast Region, Outer Continental Shelf (OCS) Operations to determine whether or not such sales were in compliance with the Mandator Pricing Regulations. The audit period covered sales transactions which occurred from September 1973 through September 30, 1976. The audit disclosed:

Appendix 4

1. USGS received $1,071,738.79 in excess of the applicable "old" oil ceiling prices as shown below:

Property	"Old" Crude Classified as N/R	Prices in Excess of Ceiling	Total
OCS-1194		$ 924,722.54	$ 924,722.
OCS-0423		66,064.94	66,064.
OCS-0560	$ 599.84		599.
OCS-0762	2,181.77		2,181.
OCS-0775	3,707.22		3,707.
OCS-0443		74,412.48	74,412.
Total	$6,488.83	$1,065,249.46	$1,071,738.

2. By the additional charge, over allowable ceiling prices, of a one-ha (1/2) percent administrative charge to the value of royalty crude oil sold, USGS received an additional $56,942.67 in excess of the Mandatory Pricing Regulations on lower and upper tier crude oil on the following properties.

Property	Adm. Charge	Property	Adm. Charge
OCS-1194	$19,424.07	OCS-01155	$ 290.79
OCS-0423	20,576.46	OCS-01496	288.47
OCS-0560	229.41	OCS-1241	362.45
OCS-0762	728.11	OCS-1607	3,190.33
OCS-0775	1,863.47	OCS-01959	2,902.43
OCS-0443	4,399.03	OCS-01972	98.59
OCS-0898	518.00	OCS-02255	469.12
OCS-0934	7.65	OCS-02136	1,594.29
Total			$56,942.67

3. USGS does not provide purchasers with §212.131 required certification for the crude oil sold.

USGS is the royalty owner of the crude oil and gas produced from the OCS leases. Under the terms of the lease, USGS has the option to receive payment or to receive its 1/6 royalty oil in-kind. The royalty oil taken in-kind by USGS is sold to various small refiners. USGS has sold its royalty oil at an average market price per barrel rather than by the classification and ceiling price, than adds on its one-half percent administrative charge on top of this price. We estimated that USGS during the audit period had received over $2.5 million in administrative charges from approximately 31 purchasers in addition to the market value for the royalty oil sold.

The results of this audit are incorporated into an NOPV but have not been issued to USGS.

In addition to the work we have done at USGS as described above, we have received numerous complaints from firms charging USGS with violating the Mandatory Pricing Regulations by (1) being forced to pay a higher price than the regulations allow, (2) being forced to retroactively pay beyond the 60-day limit set forth in 10 C.F.R. §212.131(a)(1) and (3) failure to establish a unit base production control level for each unitized property in the OCS.

Listed below are some of the complaints received against USGS:

Date	Firm	Complaint
December 2, 1976	MAPCO	Higher prices & retroactiv pricing. (Powder River Ba Eastern Wyoming)
*October 10, 1978	Crystal Oil Co. and Adobe Refining Co.	Higher prices--upper and l tiers.
*November 2, 1978	Crystal Oil Co. and Adobe Refining Co.	Higher prices--upper and l tiers.
*December 1, 1978	Crystal Oil Co. and Adobe Refining Co.	Higher prices--upper and l tiers.
*December 29, 1978	Crystal Oil Co.	Higher prices--upper and l tiers.
*December 29, 1978	Adobe Refining Co.	Higher Prices—upper and l tiers.
*April 27, 1979	Crystal Oil Co.	Higher prices--upper and l tiers.
*April 27, 1979	Adobe Refining Co.	Higher prices--upper and l tiers.
*July 25, 1979	Crystal Oil Co.	Higher prices--upper tier retroactive billings from 1977 through March 1979.
*July 24, 1979	Adobe Refining Co.	Higher prices--upper and tier.

**August 13, 1979	Saber Refining Co.	Higher prices—upper and lo tier.
September 7, 1979	Crystal Oil Co.	Higher prices--Upper tier
September 7, 1979	Adobe Refining Co.	Higher prices--Upper and lc tiers.

*Copies of complaints forwarded to National Office of Enforcement.
**Complaint filed in National Office and forwarded to SWD for "appropriat action."

In addition to the above formal complaints filed by Crystal Oil Company, Saber, and Adobe Refining Company, we have also, during the past year, received complaints from Texaco, Gulf, Shell, Koch, Gas Producers International and Husky Oil against USGS.

The following quotes are taken from the Saber complaint:

> "The prices charged in any sale of crude oil by the federal government are subject to ceiling price limitations of the regulations contained in 10 C.F.R. Part 212. See 10 C.F.R. §212.52; California v. Simon, 504 F.2d 430 (Em. App. 1974), Cert. denied, 419 U.S. 1021 (1974); and Mohawk-Petroleum v. U. S. Navy, 521 F.2d 1394 (Em. App. 1976). The basic rule of Part 212 is that "[N]o firm...may charge a price for any covered product which exceeds the maximum price at which that product is permitted to be sold to the class of purchaser covered." §212.10(a).
>
> "With respect to first sales of domestic crude oil, no producer may charge a price in excess of the lower tier ceiling price as determined by §212.73(b) or (c), unless the crude oil is classified in one or more of the categories provided in §212.73(a) to be subject to separate price determination or exempt from the regulations. "First sale" means the first transfer for value by the producer or royalty owner. 10 C.F.R. §212.31. The definition of "producer" includes any firm which owns crude oil or natural gas when it is produced, and thus includes the USGS. 10 C.F.R. § 212.131."

We agree with this statement and would recommend issuance of an NOPV to USGS. A meeting with USGS will not resolve the issue. We have previously met formally, in May 1976 prior to formalizing our audit, with USGS in Dallas but to no avail.

HAND DELIVERED

Department of Energy
Washington, D.C. 20461

October 25, 1979

Mr. Kenneth Lee
Office of the Solicitor
U.S. Department of the Interior
Washington, D.C.

Dear Mr. Lee:

Attached is a brief summary of six enforcement issues involving practices of the U.S. Geological Survey. It is requested that you review these issues, and let Mr. William Pendergrass of my staff know if you would like to meet with him on Friday morning, October 26, at 10:00 a.m., to discuss these issues in advance of a meeting between members of the Office of the Solicitor and the Office of the General Counsel. You may reach Mr. Pendergrass at (202) 254-8700.

Sincerely,

Robert G. Heiss

Robert G. Heiss
Assistant General Counsel
for Enforcement

Attachments

cc: John Leshy
Larry McBride

Does GS calculate value of royalty taken in kind in order to calculate lawful price for sale of royalty oil?

Appendix 5

BRIEF SUMMARY OF SIX ENFORCEMENT ISSUES INVOLVING PRACTICES OF USGS

USGS sales of royalty oil without certification of volumes of upper and lower tiers of crude oil

10 CFR § 212.131 requires, inter alia, that the producer certify, in domestic crude oil sales, the volumes of lower-tier ("old") crude oil and upper-tier ("new") crude oil. USGS apparently billed one purchaser of royalty oil for crude oil sold in the first four months of 1975, without certifying any volumes of upper-tier oil. The lower-tier price was approximately $5.35 during that period, but USGS billings appear to have exceeded the lower-tier price by approximately $450,000, exclusive of interest.

USGS sales of royalty oil without regard to the property's BPCL

With regard to an offshore lease, USGS apparently sold royalty oil at exempt prices prior to February 1, 1976, and at upper-tier prices subsequently, without regard to BPCL, in violation of 10 CFR § 212.73. USGS apparently computed the selling price of royalty oil using a "ratio" method for the month of production, as follows:

$$\text{Selling Price per barrel} = \frac{\text{Gross proceeds from all production accruing to lessee (\$)}}{\text{All production from lease (barrels)}}$$

USGS sales of royalty oil based upon recertifications of crude oil outside the two-month period required by 10 CFR § 212.72 and 212.131

10 CFR § 212.73(a) limits a producer's pricing of a "first sale" to the lower-tier ceiling price except for "new" crude oil (defined in § 212.74). Furthermore, 10 CFR § 212.72 (and § 212.131) provides that new crude oil shall not include oil that is not certified as new crude oil within the consecutive two-month period immediately succeeding the month in which the crude oil is produced and sold. USGS allegedly charged a price to a purchaser of royalty oil, Young Refining Corp., based upon volumes of crude oil that had not been certified or

recertified as "new" or "upper-tier" crude oil within the two-month period required by 10 CFR §§ 212.72 and 212.131, resulting in an overcharge of $127,819.25, exclusive of interest, for sales applicable to the months of September and October 1976. In addition, another purchaser has identified $71,220.04 in alleged overcharges that have resulted from untimely recertifications of crude oil by USGS in June 1975 and January and February 1977.

USGS sales of royalty oil at "stripper well" prices based upon inclusion of injection wells in the number of wells used to determine average daily production

USGS has apparently sold royalty oil at "stripper well" prices by determining average daily production based upon the inclusion of injection wells, in violation of 10 CFR § 212.54, as interpreted by Ruling 1974-29, and DOE's Notice of Enforcement of 10 CFR § 212.54 as Interpreted by Ruling 1974-29 (March 23, 1978). DOE has excluded injection wells from the determination of a property's average daily production, since those wells are not considered as wells which "produce" crude petroleum. One purchaser has alleged that the USGS overcharge for one month, August 1979, for sales of royalty oil at "stripper well" prices based upon inclusion of injection wells in determining average daily production, was $1,112,500.

USGS sales of condensate produced from gas wells as "stripper well" exempt crude oil

As stated in Ruling 1974-28, a firm may not properly claim "stripper well" exempt status for the natural gas or condensate production of "gas wells" on a property, since these wells do not produce crude petroleum. See 10 C.F.R. § 210.32, now deleted. Investigation of an offshore property disclosed that gas wells which produced condensate were improperly classified as "stripper wells", and, as a result, USGS charged uncontrolled prices for the royalty oil produced and sold from the property, in alleged violation of 10 CFR § 212.73.

USGS' failure to maintain records

Economic Regulatory Administration auditors have noted that USGS records are apparently, in several areas, not maintained in accordance with the requirements set forth in 10 CFR §212.128(a) and (c). Specifically, it appears that USGS has failed to: compute each property's base production control level, document the highest posted prices used to determine sales of upper-tier and lower-tier crude oil from each property, produce records, on a well-by-well basis, of production from stripper well properties.

STATEMENT OF CHARLES J. MANKIN, STATE GEOLOGIST, STATE OF OKLAHOMA, ON BEHALF OF THE AMERICAN INSTITUTE OF PROFESSIONAL GEOLOGISTS, ACCOMPANIED BY RUSSELL G. WAYLAND, FORMER CHAIRMAN, LEGISLATIVE AND REGULATORY COMMITTEE, AMERICAN INSTITUTE OF PROFESSIONAL GEOLOGISTS; AND A. G. EVERETT, CHAIRMAN, GOVERNMENT AFFAIRS COMMITTEE, AMERICAN INSTITUTE OF PROFESSIONAL GEOLOGISTS

Mr. MANKIN. Thank you, Mr. Chairman. I am Charles Mankin appearing this morning on behalf of the American Institute of Professional Geologists. I am chairman of the Institute's Public Affairs Committee and recently served as a member of the Commission on Fiscal Accountability of the Nation's Energy Resources.

I am accompanied today by A. G. Everett, chairman of the Institute's Government Affairs Committee and of its Committee on Access to Public Lands for Scientific and Educational Purposes, and by Mr. Russell Wayland, past chairman of the Institute's Legislative and Regulatory Committee, and presently its Washington representative.

In the interests of time I would like to submit my written statement for the record and to summarize its highlights briefly, and then we will be happy to be available for questions according to the chairman's wishes.

As a matter of introduction, I would like to say that I serve as professor of geology, director of the Oklahoma Geological Survey, and executive director of the Energy Resources Center at the University of Oklahoma. Today I am representing the 5,000 members of the American Institute of Professional Geologists in this statement.

The institute strongly supports the objectives of S. 2305 as a measure to improve the royalty management process on the Outer Continental Shelf, Federal and Indian lands. We do, however, have some suggestions for improvement of the bill, and we believe that one oversight in drafting may prove to be detrimental to use of Federal lands under lease for research, scientific or educational purposes.

Another oversight is a provision that can reduce the percentage of ultimate recovery of oil and gas from reservoirs. Specific to the bill, under section 5(c)(2) which concerns record keeping with respect to production and storage or removal of minerals from the lease site, we believe that the records should also include those minerals, including for example, natural gas, that are used on the lease site.

Section 8 specifies that every person who is a mineral resource interest holder, lessee or operator on public or Indian lands be required to prepare and maintain records of such activities required by the Secretary. Although the intent seems clear, an unnecessary burden could be imposed on many fractional interest owners by either overzealous or uninformed interpretation of the present language. As you well know, there are tens of thousands of fractional interest owners on public and Indian mineral leases who have no or only marginal knowledge of their leasehold interest. We believe the intent should be to require records of payers of leases to be

LEASE NO.	OF	P	MO/	/YR	CD	R	AC.	CMP	R IK	WELS-C	W G R	LEASE QUANTITY	LEASE VALUE	ROYALTY QUANTITY	ROYALTY VALUE
64-044124-	03		02/	/75	01	2	565		18	119		79.74	362.01	9.97	45.25
64-044182-1	03		12/	/74	01	2	565		18	123		355.10	1,602.47	44.39	200.31
64-044182-1	03		12/	/74	01	2	565		18	123		355.10CR	1,602.47CR	44.39CR	200.31CR
64-044182-1	03		02/	/75	01	2	565		18	119		298.99	1,357.45	37.37	169.68
64-044182-2	03		12/	/74	01	2	565		18	123		3,091.30	14,104.72	386.41	1,763.09
64-044210-	03		12/	/74	01	2	565		18	123		157.60	711.20	19.70	88.90
64-044210-	03		02/	/75	01	2	565		18	119		132.70	602.45	16.59	75.31
64-044210-	03		12/	/74	01	2	565		18	123		157.60CR	711.20CR	19.70CR	88.90CR
64-045461-	03		12/	/74	01	2	565		18	123		165.41	754.72	20.68	94.34
64-068977-	03		12/	/74	01		565		18	123		823.25	3,756.28	102.91	469.54
64-069212-	03		12/	/74	01		565		18	123		9,718.30	43,855.94	1,214.79	5,481.99
64-069212-	03		02/	/75	01		565		18	119		8,182.84	37,150.12	1,022.86	4,643.77
64-069212-	03		12/	/74	01		565		18	123		9,718.30CR	43,855.94CR	1,214.79CR	5,481.99CR
64-073575-	03		12/	/74	01		565		18	123		3,032.93	13,838.38	379.12	1,729.60
64-074385-	03		12/	/74	01		565		18	123		1,374.91	6,204.57	171.86	775.57
64-074389-	03		02/	/75	01		565		18	119		1,157.68	5,255.86	144.71	656.98
64-074385-	03		12/	/74	01		565		18	123		1,374.91CR	6,204.57CR	171.86CR	775.57CR
64-074743-	03		12/	/74	01		565		18	123		768.58	3,506.80	96.07	438.35
64-074744-	03		02/	/75	01		565		18	119		2,239.27	10,166.30	279.91	1,270.79
64-074744-	03		12/	/74	01		565		18	123		2,659.46CR	12,001.38CR	332.43CR	1,500.17CR
64-074744-	03		12/	/74	01		565		18	123		2,659.46	12,001.38	332.43	1,500.17
64-075459-	03		12/	/74	01		565		18	123		463.51CR	2,091.69CR	57.94CR	261.46CR
64-075459-	03		02/	/75	01		565		18	119		390.27	1,771.86	48.78	221.48
64-075459-	03		12/	/74	01		565		18	123		463.51	2,091.69	57.94	261.46
64-078254-B	03		12/	/74	01		565		18	123		438.91	2,002.64	54.86	250.33
64-079448-	03		12/	/74	01		565		18	123		37.47	170.98	4.68	21.37
64-080683-	03		02/	/75	01		565		18	119		11,066.41	50,241.53	1,383.30	6,280.19
64-080683-	03		12/	/74	01		565		18	123		13,142.95CR	59,310.43CR	1,642.87CR	7,413.80CR
64-080683-	03		12/	/74	01		565		18	123		13,142.95	59,310.43	1,642.87	7,413.80
SUB-TOTALS FOR SOURCE CODE 565 WITHIN RIK CODE 18												51,941.75	236,185.13	6,492.76	29,523.17
01-000312-2	03		02/	/75	01		769		18	31		85,281.81	399,848.17	12,670.30	60,343.05
SUB-TOTALS FOR SOURCE CODE 769 WITHIN RIK CODE 18												85,281.81	399,848.17	12,870.30	60,343.05
TOTAL FOR RIK CODE 18												[illegible]	[illegible]	[illegible]	[illegible]

held responsible for each lease such as lessees, operators, and working interest owners.

Further, under section 9(d) the provision for a limit of 3 years in suggesting a refund for overpayment, the time limit is exceedingly short in view of the fact that in some instances the overpayment made occurs because of differing interpretations of fair market value of the mineral commodity. Since there is no specific time established for the Secretary to render a decision on the meaning of fair market value for a given mineral commodity such a time constraint places an unreasonable hardship and is contrary to the plain intent of the provision.

Section 13 is in one sense an anticonservation measure in that this would tend to reduce incentive to maximize the ultimate recovery of oil and gas from certain types of reservoirs.

The provisions of section 13(a)(a) can be read as follows:

> Royalty shall be due on natural gas used for reinjection to conserve both gas and the reservoir measures needed to maximize ultimate resource recovery.

We recommend that the proviso be extended to read that:

> No royalty shall be due on gas which is flaired with prior approval from the Secretary or which is reinjected in the lessor's unit for its conservation, for pressure maintenance or for enhanced recovery.

Section 20 refers to assessment of a percentage of royalty collection to support royalty management activities. This section is flawed by vagueness as to the responsibility for its implementation. Furthermore, as drafted, it could be interpreted to place a limit on the appropriation of funds for royalty management activities. For example, the 1 percent limit would produce an assessment of less than $50-million annually at the present royalty collection payments. If this amount must be equal to the amount appropriated for royalty collection activity, then it would place a limit on the amount allocated for such activity.

In making this recommendation, the Commission on Fiscal Accountability intended this assessment to create a self-sustaining fund to be a supplement to the regular appropriation to pay for increased numbers of audits, increased inspection activities, and for cooperative agreements with States and Indian tribes. As drafted, section 20 does not adequately reflect the clearly stated recommendations of the Commission.

In addition to the above listed items, S. 2305 does not sufficiently address issues for other leaseable mineral commodities such as coal, uranium, and other leaseable minerals. With all due respect to the comments earlier by Secretary Pendley, this bill is in fact a bill dealing with oil and gas production throughout its entire intent. There are some very specific issues with respect to coal, uranium, and other minerals that are not addressed in this legislation but deserve prompt attention.

In addition, the proposed legislation is also silent on one of the most important issues in royalty minerals management, that of fair market value for each of the mineral commodities. It is in the best interests of all concerned to have the Secretary render a definition of fair market value for each mineral commodity in an expeditious manner.

With all due respect to earlier testimony, there is in fact in place at the present time a Secretarial decision that, for example, on coal, the market price shall be defined as the fair market value. This issue is of extreme importance in dealing with the question of natural gas.

The American Institute of Professional Geologists notes with concern that section 310 defining mineral resource fails to designate a de minimis volume of material that may be removed for scientific, educational, research purposes such as for energy research studies. That omission appears to make applicable the sanctions of the act were it to become law for any removal of any volume whatsoever, no matter how small, of all geological substances presently leaseable in volume were such material to be collected for scientific, educational, or research purposes. We believe this is an inadvertent oversight, but it is one that we believe needs to be corrected. It is clearly not the intent of the administration of the Congress to cast so-called inhibitors of future research on Federal lands.

Thus we recommend a modification permitting de minimis collection of samples for research, scientific and educational purposes to the same extent as now permitted through the existing process and procedures.

The American Institute of Professional Geologists supports the broad objectives of S. 2305 and its effort to implement parts of the recommendations of the Commission on Fiscal Accountability of the Nation's Energy Resources. The Institute believes that improvement of the present royalty management system for Federal resources must have a high priority with both the Congress and the administration.

The problem of making Federal resources management more business-like and responsive to the Nation's needs does not stop there, however. We applaud Secretary Watt's creation of a Minerals Management Service as a separate bureau within the Interior Department. At present, however, it does no more than structurally reorganize the former Conservation Division of the U.S. Geological Survey. In our opinion, that does not address the heart of the issue.

The heart of the issue is at the moment the royalty collection, accounting, and related regulatory processes, and what we have with the Minerals Management Service is simply a new name for the Conservation Division with a different reporting requirement that contains all of the present preleasing functions as well.

We believe that the focus should be to address first the issue of royalty collection and accounting and related regulatory responsibilities, and then to look more broadly at the entire leasing function of minerals management within the entire Federal Government to address those issues that pertain within other bureaus and indeed even other secretariats of Federal Government.

We trust that these much-needed additional steps will follow quickly upon the resolution of the royalty management problem. It has been apparent for some time that the Nation's onshore public lands do not provide our society with their fair share of the Nation's resource needs. We believe that a more orderly minerals management program for public and Indian lands is needed by the Federal Government.

As representatives of the professional geological community, we stand ready to work with the committee, the Congress, and the administration to develop such an urgently needed comprehensive Federal resource management system. We hope these observations will be of some assistance in considering modifications of S. 2305.

We appreciate the opportunity of being here today on behalf of the American Institute of Professional Geologists.

Thank you.

[The prepared statement of Mr. Mankin follows:]

AMERICAN INSTITUTE OF PROFESSIONAL GEOLOGISTS

STATEMENT ON SENATE BILL 2305

"Federal Energy and Mineral Resources Act"

Charles J. Mankin

on behalf of

AMERICAN INSTITUTE OF PROFESSIONAL GEOLOGISTS
2828 Vance Drive
Arvada, CO 80003

I am Charles J. Mankin. I serve as a Professor of Geology, Director of the Oklahoma Geological Survey, and Executive Director of the Energy Resources Center at the University of Oklahoma. I am here today on behalf of the American Institute of Professional Geologists, an organization chartered to further the professional affairs of geological scientists.

The Institute strongly supports the objectives of S 2305 as a measure to improve the royalty management process on Outer Continental, Federal and Indian lands. We do, however, have some suggestions for improvement of the bill, and we believe that one oversight in drafting may prove to be detrimental to use of Federal lands under lease for research, scientific or educational purposes. Another oversight is a provision that can reduce the percentage of ultimate recovery of oil and gas from reservoirs.

I am personally interested in S 2305 because I served as a member of the Commission on Fiscal Accountability of the Nation's Energy Resources, established by Secretary Watt to investigate the allegations of royalty underpayment, mismanagement, fraud, and physical theft of mineral resources from the Nation's public and

Indian lands. Because of this involvement, I feel qualified to evaluate the contents of this proposed legislation.

The general thrust of S 2305 does indeed address many of the findings and recommendations of the Commission on Fiscal Accountability. As such, it represents an important step toward correcting many of the problems that exist in the management of mineral and energy production from the Nation's public and Indian lands. However, there are several issues that need further consideration. Some of these are as follows:

Section 5(c)(2) concerns record-keeping with respect to production, storage or removal of minerals from a lease site. Such records should also include minerals (e.g. natural gas) used on the lease site.

Section 8 specifies that every person who is a mineral resource interest holder, lessee, or operator on public or Indian land be required to prepare and maintain records of such activities as may be required by the Secretary. Although the intent seems clear, an unnecessary burden could be imposed on many fractional interest owners by either overzealous or uninformed interpretation of the present language. There are tens of thousands of fractional interest owners in public and Indian mineral leases who have no, or only marginal, knowledge of their leasehold interest. It is our belief that the substantial increase in parties, as owners of partial interests in leases, to be held responsible for payment, record-keeping, verification, and enforcement will defeat the intent of the improved system before it can get off of the ground. If the payer of record issue does expand the number of responsible parties from the present number of operators responsible for 18,000 leases to the estimated total of some 600,000 taxpayers, the presently inadequate system will not be improved in the near future. Furthermore, the provisions of Section 20 regarding an allocation of not more than one percent of collected revenues is not apt to be sufficient to allow significant oversight and enforcement of the royalty payment program. The intent should be to require records of "payers of record" held responsible for each lease, such as lessees, operators, and working-interest owners.

Section 9(b) provides for a limit of three years in requesting a refund for overpayment. The time limit is exceedingly short in view of the fact that, in some instances, the overpayment may occur because of differing interpretations of "fair market value" of the mineral commodity. Since there is no specific time establisned for the Secretary to render a decision on the meaning of "fair market value" for a given mineral commodity, such a time constraint on the mineral producer poses an unreasonable hardship and is contrary to the plain intent of the provision.

Section 13 is in one sense anti-conservational in that it would tend to reduce the incentive to maximize the ultimate recovery of oil and gas from certain types of reservoirs. The provision of Section 13(a)(1) can be read as follows: "Royalty xxx shall be due xxx (on natural gas) xxx used for (reinjection to conserve both the gas and the reservoir pressures needed to maximize ultimate resource recovery)". We recommend that the proviso be extended to read "That no royalty shall be due on gas which is flared with prior approval from the Secretary, or which is reinjected in the lease or unit for its conservation, for pressure maintenance, or for enhanced recovery".

Section 20 refers to an assessment of a percentage of the royalty collection to support the royalty management activities. This section is flawed by vagueness as to the responsibility for its implementation. Furthermore, as drafted, it could be interpreted to place a limit on the appropriation of funds for royalty management activities. For example, the one percent limit would produce an assessment of less than $50 million annually at present royalty collection amounts. If this amount must equal the amount appropriated for royalty collection activities, then it would place a limit on the amount allocated for such activities. In making this recommendation, the Commission on Fiscal Accountability intended this assessment to create a "Self-Sustaining Fund"* to be a supplement to the regular appropriation to pay for an increased number of audits, increased inspection activities, and for cooperative agreements with States and Indian tribes. As drafted, Section 20 does not adequately reflect the clearly stated recommendations of the Commission.

In addition to the above-listed items, S 2305 does not sufficiently address issues for other leasable mineral commodities such as coal, uranium, and other leaseable minerals. Issues with respect to these commodities deserve early, prompt attention. The proposed legislation also is silent on one of the most important issues in royalty minerals management - that of "fair market

* For discussion in the Commission's report, see see pages 257-259.

value" for each of the mineral commodities. It is in the best interest of all concerned to have the Secretary render a definition of "fair market value" for each mineral commodity in an expeditious manner.

The American Institute of Professional Geologists notes with concern that Section 3 (10), defining "mineral resource", fails to designate a de minimus volume of material that may be removed for scientific, educational, or research purposes, such as for energy research studies. That omission appears to make applicable the sanctions of the Act, were it to become law, for any removal of any volume whatever, no matter how small, of all geological substances presently leasable in volume, were such material to be collected for routine scientific, education or research purposes. We believe that this is an inadvertent oversight. It is clear that the present prohibited acts of Section 14(4)(5) and the penalties of Sections 15(1) and 16(a), if enacted, would create an unintended and undesired impediment to scientific and educational work on Federal land. This impediment can be remedied without impairing whatever the highly salutary intent of the Bill. From a practical point of view, in the course of geological work on Federal lands it is neither feasible nor possible to locate all leaseholders on all tracts upon which regional studies take place. The determination of lessees to be contacted, royalty owed, and paperwork to be undertaken for each sample, commonly of a pound or less, of oil shale, coal, phosphate-bearing rocks, or other geologic materials would effectively prohibit research and educational use of leased public lands. It is clearly not the intent of the Administration or the Congress to cast so broad a net or so inhibit future research on Federal lands. Thus we recommend a modification permitting de minimus collection of samples for research, scientific, and educational purposes to the same extent as is now permitted through existing processes and procedures.

The American Institute of Professional Geologists supports the broad objectives of S 2305 in its efforts to implement parts of the Commission on Fiscal Accountability of the Nation's Energy Resources. The Institute believes that improvement of the present royalty management system for Federal resources must have a high priority with both the Congress and the Administration. The problem of making Federal resources management more business-like and responsive to the Nation's needs does not stop there, however. We applaud Secretary Watt's creation of a Mineral Management Service as a separate bureau within the Interior Department. At present, however, it does no more than structurally reorganize the former Conservation Division of the U.S. Geological Survey. As yet, it does not centralize Federal leasing proecedures, unify the presently scattered functions of Federal minerals and energy resources management, or focus through a single responsible Federal entity the Nation's objectives for utilization of mineral and fuels resources by significaant exploration and production efforts on the Nation's public and Indian lands. We trust that these much-needed additional steps will follow quickly upon resolution of the royalty management problem. It has been apparent for some time that the Nation's onshore public lands do not provide our society with their fair share of the Nation's resource needs. We believe that a more orderly minerals management program for public and Indian lands is needed by the Federal Government. As representatives of the professional geologic community, we stand ready to work with the Committee, the Congress, and the Administration to develop such an urgently needed, comprehensive Federal resource management system.

We hope these observations will be of some assistance in the consideration of modifications of S 2305. We appreciate the opportunity of being here today on behalf of the American Institute of Professional Geologists.

Senator WALLOP. Mr. Mankin, may I say from my perspective I appreciate your taking the time to avail yourself of this opportunity. The idea of time to work on legislation would be endlessly improved if all of the testimony were as articulate and as precisely directed as yours has been.

Do you have any language that you can recommend to us or could you get us some recommended language regarding the de minimis uses for scientific and other purposes?

Mr. MANKIN. We do not have, but we will be happy to provide that very shortly.

Senator WALLOP. I am sure it is an oversight. It is obvious that looking at the broader picture people sometimes forget the specifics of some of the ordinary functions that go on. As well I agree with your recommendations that we ought to deal first with the post-leasing functions and deal later with the prelease problems. That is what after all is the problem primarily now.

We very much appreciate your coming today. Thank you. The next witness is Mr. Laurence Steenburg, past president of the American Petroleum Refiners Association. Good afternoon:

Mr. STEENBERG. Good afternoon:

STATEMENT OF LAURENCE R. STEENBERG, FORMER PRESIDENT, AMERICAN PETROLEUM REFINERS ASSOCIATION

Mr. STEENBERG. Good afternoon. My name is Larry Steenberg. I am appearing on behalf of the American Petroleum Refiners Association of which I am past president, to address section 12 of the Senate bill 2305.

This particular section it would appear has little relevance to the stated purposes of the legislation, and APRA urges its deletion by the committee.

The purpose of S. 2305 is to grant to the Secretary of the Interior the necessary authority to properly manage and better account for the production of energy and mineral resources from our public lands. However, section 12 of the bill does not relate to that end. It is a disingenuous, and I might add in my opinion an arrogant attempt by the Department of the Interior to achieve total amnesty from past misdeeds relating to improper pricing of oil, of crude oil sold by the Department of Interior to private industry. These improper pricing practices began as early as 1974 and have continued well beyond January of 1981, the point at which crude oil prices were decontrolled.

The Department is currently involved in litigation with a number of companies who have filed complaints seeking the recovery of alleged overcharges on crude oil purchased. Section 12 of this bill if adopted by the Congress would bar any existing claim or potential claim against the Department of Interior for the Department's failure to comply with the crude oil pricing rules, the same rules which were strictly applied to private industry during the period of price controls.

APRA believes it is wrong for the Department of Interior as the largest domestic producer of crude oil to attempt to escape responsibility for failure to comply with the law.

Mr. Chairman, a bit of history and a specific example would best illustrate what APRA believes to be the failings of the Interior Department in this area. From 1974 to date, small refiners have been substantial purchasers of Government royalty crude oil. In April of 1974 the Federal Energy Office, which is the predecessor to DOE, specifically placed Federal and State governments, including the Department of the Interior, under the mandatory petroleum price regulations of the FEA. Subsequent court decisions confirmed that the Federal Government was subject to FEA/DOE pricing regulations.

These regulations controlled the maximum prices at which domestic crude oil could be sold in the first sale following its production. All crude oil producers, including the Department of Interior, were specifically required to follow these regulations. In fact, I have looked on royalty oil contracts. I have found recent contracts specifically allude to the fact that the contractor is bound by the laws that I am referring to, the regulations under EPAA.

However, the fact that the Department of Interior was subject to the Department of Energy pricing and allocation rules gave no assurance that Interior would in fact follow the rules which by law applied to every U.S. producer of crude oil, including the U.S. Government. Originally Interior refused to supply purchasers with any price control certifications whatsoever as they were required by law to do. Later in 1975 the USGS reluctantly provided general price control information to refiner/purchasers which was based upon improperly determined data. In many cases, these reports were not timely, and they often bore little relationship to actual current production figures on the leases in question.

When it was to the advantage of the Department, this pricing net was retroactively changed as far back as 6 months, a practice clearly prohibited by law, and refiner/purchasers were told to pay up within 10 days or have their royalty contracts terminated and their letters of credit attached. During late 1970 I was president of a small asphalt refining company which purchased crude oil under several USGS royalty oil contracts, and I have firsthand experience with such improper attempts to overcharge firms who are buying Government crude oil.

Asphalt refiners run very low gravity, poor quality crude oil. During 1979 and 1980, our company was purchasing low quality USGS crude and paying a control price of about $6 a barrel. In May of 1980 we received a retroactive price increase from USGS stating that the price controlled crude we had been purchasing for the past 5 months at about $6 a barrel was actually decontrolled crude oil worth $38 a barrel. Our crude oil stream had increased in price by $32 a barrel or about 600 percent, and we were retroactively billed for $6 million. I can tell you that it is difficult for a small businessman to raise $6 million in 10 days.

We would never have knowingly paid $38 a barrel for crude oil of that quality during that period, but we were denied the opportunity to exercise that judgment by the late notice of the price increase by the Department of Interior. Of course, there was no opportunity to recoup that increased crude cost in the price of product. The product had long since been refined and sold. This retroactive price increase would not have been tolerated had we been purchasing crude from a private producer, and that single transaction kept our company from showing a profit during 1980.

These and other similar overcharges were in violation of DOE price and allocation rules to which the DOI was clearly subject. These overcharges are not the product of technical legal points by lawyers attempting to hold the Department to a standard more strict than that imposed on other crude producers. They are substantive in nature and had many of the refiner/purchasers known what the crude oil they were buying was ultimately going to cost, they would not have purchased the oil.

Mr. Chairman, the majority of the provisions in S. 2305 are a desirable attempt to create an effective royalty management system. The 60 specific recommendations of the Linowes Commission relate to the need for improvements in existing accounting practices. Section 12 of S. 2305 is not based in any way upon the recommendations of the Linowes Commission. Section 12, narrowly put, represents even to a nonlawyer like myself an example of an ex post facto law, and I was interested in the question of constitutionality that you asked earlier. Granting the Department of Interior immunity for prior misdeeds in a piece of legislation designed to improve future royalty management seems a poor way to get the program off to a successful start.

APRA is not asking that this committee agree with our position on all of the specifics regarding DOI pricing policies during the period of price controls. We do ask that you do not bar our legal right to have these points decided in a court of law.

I would like to make one final point regarding S. 2305. The bill from our point of view contains a significant omission. In 1978, the Outer Continental Shelf Lands Act amendments required that lessees offer on all new OCS leases entered into after the date of the act 20 percent of the production for sale to small and independent refiners at market prices. Significant volumes of crude oil and natural gas liquids are already being produced under these leases, yet the intent of Congress is being ignored.

The Interior Department has specifically refused to implement necessary regulations to insure that this production is offered in accordance with the intent of the law. We urge the committee to include final language in S. 2305 to correct the situation before yet another royalty management problem arises.

I thank you for the opportunity to speak, and I would be glad to answer any questions that you might have.

[The prepared statement of Mr. Steenberg follows:]

ORAL STATEMENT
OF
LAURENCE R. STEENBERG
ON BEHALF OF THE
AMERICAN PETROLEUM REFINERS ASSOCIATION
BEFORE THE
SENATE ENERGY COMMITTEE
ON
S. 2305
THE FEDERAL ENERGY AND MINERAL RESOURCES ACT OF 1982

WASHINGTON, D.C.

MONDAY
MAY 3, 1982

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

MY NAME IS LARRY STEENBERG. I AM APPEARING THIS MORNING ON BEHALF OF THE AMERICAN PETROLEUM REFINERS ASSOCIATION (OF WHICH I AM A PAST PRESIDENT) TO ADDRESS SECTION 12 OF SENATE BILL 2305. THIS PARTICULAR SECTION, IT WOULD APPEAR, HAS LITTLE RELEVANCE TO THE STATED PURPOSES OF THE LEGISLATION AS DEFINED IN SECTION 2, AND APRA URGES ITS DELETION BY THE COMMITTEE.

THE PURPOSE OF S. 2305 IS TO GRANT TO THE SECRETARY OF THE INTERIOR (AND THE NEWLY CREATED MINERAL MANAGEMENT SERVICE) THE NECESSARY AUTHORITY TO PROPERLY MANAGE AND BETTER ACCOUNT FOR THE PRODUCTION OF ENERGY AND MINERAL RESOURCES FROM OUR PUBLIC LANDS. HOWEVER, SECTION 12 OF THE BILL DOES NOT RELATE TO THIS END. IT IS A DISINGENUOUS ATTEMPT BY THE DEPARTMENT OF INTERIOR TO ACHIEVE TOTAL AMNESTY FROM PAST MISDEEDS RELATING TO SALES OF ROYALTY CRUDE OIL. THESE IMPROPER PRICING PRACTICES BEGAN AS EARLY AS 1974 AND HAVE CONTINUED WELL BEYOND JANUARY OF 1981, THE POINT AT WHICH CRUDE OIL PRICES WERE DECONTROLLED. THE DEPARTMENT IS CURRENTLY INVOLVED IN LITIGATION WITH A NUMBER OF COMPANIES WHICH HAVE FILED COMPLAINTS SEEKING THE RECOVERY OF ALLEGED OVERCHARGES ON CRUDE OIL PURCHASED. SECTION 12 OF THIS BILL, IF ADOPTED BY THE CONGRESS, WOULD BAR ANY EXISTING CLAIM OR ANY POTENTIAL CLAIM AGAINST DOI FOR THE DEPARTMENT'S FAILURE TO COMPLY WITH THE CRUDE oil pricing rules which applied to private industry during the period of price controls. APRA believes that it is wrong for the Department of Interior, as the largest domestic producer of crude oil, to attempt to escape responsibility for complying with the law.

Mr. Chairman, a bit of history and a specific example would best illustrate what APRA believes to be the failings of the Interior Department in this area. From 1974 to date, small refiners have been substantial purchasers of government royalty crude oil. In April of 1974 the Federal Energy Office (the predecessor to DOE) specifically placed federal and state governments (including the Department of Interior) under the mandatory petroleum price regulations of the FEA. Subsequent court decisions confirmed that the federal government was subject to FEA/DOE pricing regulations. *Mohawk Petroleum Corporation* vs. *Department of the Navy*. These regulations controlled the maximum prices at which domestic crude oil could be sold in the first sale following its production. All crude oil producers (including the Department of Interior) were specifically required to follow these regulations.

However, the fact that DOI was subject to DOE pricing and allocation rules gave no assurance that DOI would follow the rules which, by law, applied to every U.S. producer of crude oil including the U.S. government. Originally, DOI refused to supply purchasers with any certifications whatsoever.

Later, in 1975, the U.S. Geological Survey reluctantly provided general information to refiner/purchasers which was based upon incorrect estimations of old and new volumes of oil. In many cases, these reports were not timely and often bore little relationship to the actual current production figures on the leases in question. When it was to the advantage of the Department, this information was retroactively changed as far back as six months -- a practice clearly prohibited by law -- and refiner/purchasers were told to pay within ten days or have their royalty oil contracts terminated.

During the late 1970's I was president of a small asphalt refining company with several USGS royalty oil contracts, and have had first hand experience with such improper attempts to overcharge firms which were buying government crude oil. Asphalt refiners run a very low gravity, poorer quality crude oil. During 1979, our company was purchasing low quality USGS crude oil and paying approximately $6.00/bbl. In May of 1980, we received an invoice from USGS stating that the crude we had been purchasing for the past five months was actually decontrolled crude oil worth $38.00/bbl. Our crude oil stream was increased in price by $32.00/bbl, a 600 percent increase, and we were retroactively billed for $6 million. I can tell you that it is very difficult for a small businessman to raise $6 million over a ten-day period. No refiner -- particularly an asphalt refiner -- would have ever knowingly paid $38.00/bbl for crude oil of that quality during that period of time.

Of course, there was no opportunity to recoup the increased (recertified) raw material costs in the price of products, for the refined products had long since been processed and sold. This retroactive price increase would not have been tolerated had we been purchasing the crude from a private producer -- and this single overcharge kept our company from showing a profit during 1980.

These and other similar overcharges were in violation of the DOE price and allocation rules to which the DOI was clearly subject. These overcharges were not the product of technical legal points by lawyers attempting to hold the Department to a standard more strict than that imposed on other crude producers. Most of the overcharges were substantive in nature, and had many of the refiners known in the first instance what the crude oil they were buying was ultimately going to cost, their companies would not have purchased the oil.

Mr. Chairman, the majority of the provisions in S. 2305 are a desirable attempt to create an effective royalty management system. The sixty specific recommendations of the "Linowes Commission" relate to the need for improvements in existing accounting practices. Section 12 of S. 2305 is not based in any way on the recommendations of the Linowes Commission. Section 12, narrowly put, represents, even to a nonlawyer like myself, an example of an "ex post facto" law.

It may well be that if the specific provisions in S. 2305

HAD BEEN IN EFFECT IN 1974, SOME OF THE OVERCHARGES WOULD NOT HAVE OCCURRED. THIS IS NOT THE POINT HOWEVER. GRANTING THE DEPARTMENT OF INTERIOR IMMUNITY FOR POSSIBLE PRIOR MISDEEDS IN A PIECE OF LEGISLATION DESIGNED TO IMPROVE FUTURE ROYALTY MANAGEMENT SEEMS A POOR WAY TO GET THE PROGRAM OFF TO A SUCCESSFUL START.

APRA IS NOT ASKING THAT THIS COMMITTEE AGREE WITH OUR POSITION ON ALL OF THE SPECIFICS REGARDING DOI PRICING POLICIES DURING THE PERIOD OF PRICE CONTROLS. WE DO ASK THAT YOU NOT BAR OUR LEGAL RIGHT TO HAVE THESE POINTS DECIDED IN A COURT OF LAW.

I WOULD LIKE TO MAKE ONE FINAL POINT REGARDING S. 2305. THE BILL, FROM OUR POINT OF VIEW, CONTAINS A SIGNIFICANT OMISSION. THE 1978 OUTER CONTINENTAL SHELF LANDS ACT AMENDMENTS REQUIRE THAT LESSEES OFFER, ON ALL NEW OCS LEASES ENTERED INTO AFTER THE DATE OF THE ACT, 20 PERCENT OF THE PRODUCTION FOR SALE TO SMALL AND INDEPENDENT REFINERS AT MARKET PRICES. SIGNIFICANT VOLUMES OF CRUDE OIL AND NGL'S ARE ALREADY BEING PRODUCED ON THESE LEASES, YET THE INTENT OF CONGRESS IS BEING IGNORED. THE INTERIOR DEPARTMENT HAS SPECIFICALLY REFUSED TO IMPLEMENT NECESSARY REGULATIONS TO ENSURE THAT THIS PRODUCTION IS OFFERED IN ACCORDANCE WITH THE INTENT OF THE LAW. WE URGE THE COMMITTEE TO INCLUDE FINAL LANGUAGE IN THE BILL TO CORRECT THIS SITUATION BEFORE YET ANOTHER ROYALTY MANAGEMENT PROBLEM ARISES.

THANK YOU. I WILL BE HAPPY TO ANSWER ANY QUESTIONS YOU MAY HAVE.

Senator **Wallop**. Mr. Steenberg, thank you. I have been inclined to agree with you. As you know, former Governor Hathaway's letter goes to that same point.

In your closing remarks about the COS Lands Act, I guess my own feeling is that probably that is better dealt with, with amendments to that act rather than at this point, but let me just ask you, it is my understanding that Interior does not believe that it has an obligation to monitor the terms of this provision as it presently exists.

What do you believe its responsibility is or should be or, you know, if you have a recommendation for specific legislative relief, whether we apply it to this or to the original piece of legislation?

Mr. **Steenberg**. I believe the original legislation is sufficient, and it sets out precisely what the intent of the Congress was.

What is needed are a set of regulations which will guide and allow the sale of the 20 percent from the lessee to the small refiner. I don't blame the lessees for refusing to sell such oil to small refiners because they have no guidelines under which they may do so. ARPA submitted a petition to the Department of Interior specifically requesting that they issue such regulations, and I believe offering some suggestions on how to do so. We were specifically turned down. The Department said it was not going to issue such regulations and did not intend to.

In the absence of those regulations, I don't believe there is any oil going to be sold under that provision of the law.

Senator **Wallop**. I have been told, I don't know whether correctly or incorrectly, that a number of small refiners have recently terminated their royalty oil contracts. Inasmuch as any crude has to be sold at market value under the provisions of the OCS Lands Act, wouldn't it be unlikely that small refiners at the current time will be interested in purchasing such oil even if the Department were to specify and suggest how that would be accomplished?

Mr. **Steenberg**. I would agree that this afternoon there would not be a great rush to enter into such contracts. I don't believe the current situation in the oil market is of very long standing. That provision of the law is there to provide small and independent refiners a place to go when oil gets very tight. The absence of regulations which would allow that to happen, meaning that if a shortage were to occur in the near future the first thing which would have to be done is to get the regulations implemented, followed by the exercising of the contracts—I think it would be prudent for you to put the regulations in place today when there is no crisis so that when the crisis occurs we have the regulations there and the business of allocating the oil can go smoothly.

Senator **Wallop**. OK. You know, in your testimony where you refer to the problems of section 12, you presently have a lawsuit against the Department filed in some kind of active state?

Mr. **Steenberg**. That is correct.

Senator **Wallop**. Explain to me if you can—I have never heard anybody who could—but how the entitlements program worked in that whole area.

Your testimony simply stated I guess contends that the Department of Interior illegally imposed some overcharges, contemplating DOE pricing regulations, and the overcharges occurred during the period of entitlement, so wouldn't it be true under that that the overcharges were equalized somehow or another or were intended to have been equalized somehow or another under the entitlements program?

Mr. **Steenberg**. There are two answers to that. One of them is "no," and the other takes about 4 hours.

Senator **Wallop**. The one with the 4 hours I am perfectly willing you tell that to somebody on the staff.

Mr. **Steenberg**. I think it is safe to say here the entitlements program in its infinite complications during the period of time we are talking about simply failed to equalize prices, and that the differences were enormous. If you simply look at the basic part of the entitlements program which applied without all the side rules, the discrepancy during 1978 and 1979 got as high as $10 a barrel between the difference after entitlements imported oil and after entitlements lower tier domestic crude oil. If you add to that all of the little side issues that go with entitlements, the differences get larger and larger.

The entitlements program simply did not equalize those costs. The damages caused by the actions of Interior are real. It represents real cash that left companies' hands for reasons that are in violation of regulations, and the cash stayed out after the entitlements program. If you would like a longwinded, technical dissertation I would be glad to write it and submit it to you.

Senator **Wallop**. I am aware to some extent of your problems. Refiners in my State have similar kinds of problems. Some of us would have said entitlements weren't going to work in the first place had we been consulted on that, but one of the problems that always exists in this world, anybody with the remotest amount of experience in the industry has automatically discounted us with the advice that they gave, and generally speaking, that discounting ends up with the sort of problems that we have got in the entitlements program and other kinds of pricing constraints, production constraints and equalization program.

I appreciate what you have said here this morning, and I believe that we will do some things to section 12. I think the advice and counsel is wise, and even if we don't, I don't believe that the courts would permit us to absolve the Department of any accountability for transactions. I don't think the Congress has that authority, so I appreciate it, and one other thing, Mr. Mankin, we will ask you if you might consider doing for us, give us some kind of advice as to how you would write fair market value definitions. I think that is long overdue.

It troubles the committee as it works for other things, not the least of which is the phosphate deposit and a number of other places, so it would be helpful to have some advice.

With that, I thank everybody for their testimony here this morning. Before I do adjourn, there is a letter to Chairman McClure describing a letter from Mr. Mut in Arco Oil and Gas Co. That letter and Mr. Mut's letter—I beg your pardon. I still have one more. I'm hungry I guess.

Mr. Smith, I apologize. Let me do the Arco letter first and put that in the record.

[The letter follows:]

ARCO Oil and Gas Company
Post Office Box 2819
Dallas, Texas 75221
Telephone 214 651 4206

Stuart C. Mut
Senior Vice President

May 3, 1982

The Honorable James A. McClure
Chairman
Committee on Energy and Natural Resources
United States Senate
Washington, D.C. 20510

Re: S-2305, the "Federal Energy and
Mineral Resources Act of 1982"

Dear Mr. Chairman:

This letter pertains to the May 3, 1982, scheduled hearings on S-2305, the "Federal Energy and Mineral Resources Act of 1982." ARCO Oil and Gas Company would like to provide the Committee its views on this important legislation and repectfully request that this letter together with the attached detailed comments be made a part of the hearing record.

We are very supportive of the goals of the Commission on Fiscal Accountability of the Nation's Energy Resources in seeking to assure the payment of all royalties due on Federal and Indian oil and gas leases and of avoiding oil thefts from Federal and Indian leases. As a long term major holder of Federal and Indian leases we have a very strong commonality of interest with the Congress and the Commission in this matter. We would urge the Congress in its careful deliberations on this legislation to exercise great caution to ensure that the final legislation will indeed provide significant movement toward solving the problems without creating large scale administrative and financial burdens for both the industry and the government.

While we support the stated purpose of S-2305, we have very serious reservations about certain provisions of the bill and certain of the Commission's recommendations. These would include:

- A requirement that an operator notify the Department of the Interior by telegram, or its equivalent, the first day after new production begins on a lease. This could impose an unnecessarily harsh burden upon operators in remote areas without serving any substantive purpose. Operators are currently required to file a monthly report on each well on Federal and Indian leases. The information on this form serves as notification of the beginning of production from each new well immediately after the month in which it occurs. With a minor modification the form could also be used to provide the precise date of first production if that information is needed.

- The recommendation that a single payor be designated for each lease. This is impractical in many cases. A single Federal lease may include several individual producing properties having no common ownership and each with a different operator. In such cases, if one operator were designated as payor for the entire lease, he would have no contractual mechanism for securing the necessary data and cooperation from other operators and owners, but he would be liable for any resultant mispayment of royalties. A more reasonable solution to the Commission's concern would be to require a payor plan which would account for 100 percent of the royalty obligation on each producing property, and to further require each payor to advise the federal royalty manager each time a change in his payor status occured.

- The recommendation pertaining to prohibiting the purchase of undocumented crude oil and requiring purchasers of crude oil, including refiners, to maintain documentation identifying the seller and the lease or unit from which the oil came. Compliance with a requirement to identify the lease or unit where the oil was produced would be possible only where oil is trucked directly from a lease to a refinery. Oil which is transported by pipeline is co-mingled with other crude oil and is impossible to trace from the point of origin to the refinery.

- The recommendations relating to site security as a crude oil theft deterrent. While reasonable measures for site security are appropriate, it should be recognized that prevention of theft from leases is all but impossible. We believe that crude oil title enforcement is the strongest weapon available to reduce oil theft. The Commission's recommendation that truck haulers of oil be required to have run tickets in their possession at all times while transporting oil from Federal and Indian leases would be an effective deterrent to crude oil theft if stringently enforced.

- The concerns pertaining to "fair market value." The determination of "fair market value" of oil or gas as produced is an extremely complex issue which should not be determined in the statutes. Crude oil and natural gas markets are totally different. Substantial price variations exist in the natural gas market as a result of a combination of factors including gas price controls and the long term contract pattern which has existed in the gas market for many years. Thus, for gas there are numerous "market prices", sometimes even within the same field. Even so, most gas sales are the result of vigorous arms-length competitive negotiation and reflect the "fair market value" of the gas recognizing the realities of the natural gas market at the time the contract was negotiated. A requirement to pay royalty on an arbitrary higher price would be manifestly unfair and in some cases could render a lease uneconomic resulting in the loss of all future royalties.

- The civil and criminal penalty provisions in the proposed legislation. These penalties appear to represent a radical departure from similar provisions in existing law. An automatic civil penalty is provided for any non-compliance (including presumably clerical errors resulting in inaccurate reports). By contrast, Section 1350 of the OCSLA would apply a similar penalty, but it would be assessed only after notice of failure to comply and the expiration of a reasonable period for corrective action. We believe the civil penalty provisions of S-2305 should be changed to be consistent with the provisions in the OCS Lands Act as amended, 43 USCLA Section 1350(b).

The attached paper elaborates on our concerns about these issues. We appreciate the opportunity to offer our views to the Committee on this important matter and we would welcome the opportunity to discuss these matters further should the Committee desire.

Sincerely yours,

Stuart C. Mut

SCM:lm

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ARCO OIL AND GAS COMPANY
VIEWS ON SELECTED RECOMMENDATIONS IN THE REPORT OF THE COMMISSION ON FISCAL ACCOUNTABILITY OF THE NATION'S ENERGY RESOURCES

Shortly after becoming Secretary of the Department of the Interior, Secretary James G. Watt formed the Commission on Fiscal Accountability of the Nation's Energy Resources to investigate the Government's royalty management system and allegations of theft of oil from Federal and Indian lands, and to make recommendations to improve any shortcomings uncovered. In January of this year, the Commission reported its findings with 60 recommendations to improve the current situation.

ARCO Oil and Gas Company is very supportive of the goals of the Commission on Fiscal Accountability of the Nation's Energy Resources, the Department of the Interior and of the Congress in seeking to assure the payment of all royalties due on Federal and Indian oil and gas leases and of avoiding oil thefts from Federal and Indian leases. These are both high stakes issues and both are extremely complex issues.

We would urge the Congress in discharging its responsibilities on these matters to exercise great care to ensure that it identifies and puts in place feasible, cost effective solutions. To that end we offer the comments contained in this paper, beginning with the important observation that the Congress, the Commission and ARCO Oil and Gas Company have a very strong commonality of interest in this matter.

NOTIFICATION OF FIRST PRODUCTION

With respect to new production on a lease, the important consideration is not which day the USGS receives the notification, but rather the certainty that the USGS will be notified promptly and accurately as to the date that production commenced. Depending upon where the well is located, and perhaps depending upon the resources of the operator, notification of the USGS on the first working day following the commencement of production may not be feasible.

In many producing areas in the Western States and Alaska, drilling sites are frequently in extremely remote areas where both transportation and communication links range from very poor to non-existent. While the major oil companies might have sufficient radio and mobile telephone capabilities in such situations to enable them in most cases to overcome these handicaps and comply with a first day reporting requirement, this requirement could impose an unnecessarily harsh burden upon many small operators.

It is difficult to see that any substantive purpose would be served by a first working day notification requirement. The intent of the Commission's recommendation pertaining to notification of the USGS of establishment of new production on a lease could be achieved effectively by requiring notification on the fifth business day following the beginning of new production on a lease. The needs of the federal royalty management system could be satisfied so long as the operator advises the USGS as soon as possible after the start-up of new production and certifies to the USGS the start-up date.

We question the value of a requirement for separate notification for each new well on a lease. The presently required Monthly Report of Operations (OCS Form 9-152, Onshore Form 9-329, Indian Form 9-329-A, see Attachment I) reports the status of each well including new wells. The information on this form serves as notification of the beginning of production from each additional new well in the month immediately after it occurs. If the precise date of first production is required for some purpose, a minor modification of this form would serve that purpose.

SINGLE PAYOR RESPONSIBLE FOR ALL ROYALTY PAYMENTS

With respect to royalty payments the Commission recommended that:

A. The federal royalty managers work toward the implementation of a concept of an operator of record for each lease, and where possible a single payor, with the operator of record responsible for maintaining all records related to the payment of royalties from that lease;

B. The operator or some other agent be required to submit a payor plan for the lease signed by all payors indicating the payment responsibilities of each party, and submit updates as changes occur; and

C. Each month after royalty payments are made, the operator of record be required to reconcile the payments with the production reports, notify the Minerals Management Service of any discrepancies, and provide the correct data.

While S.2305 does not specifically address the single payor/operator of record issue, it may be sufficiently broad to permit the Secretary to require such an arrangement. HR.5121 specifically addresses the single payor issue, stating "the Secretary is authorized to designate a principal lessee with respect to any lease, who shall be responsible to make all royalty and lease payments to the Secretary under such lease". We recognize the Minerals Management Service's need to verify that proper royalties are received for oil and gas produced from Federal and Indian leases. However, we are very much concerned about the implications of the single payor concept.

The designation of a single payor on a federal lease who would be responsible for making all royalty and lease payments to the Secretary of the Interior is impractical in many cases. A single federal lease may include a number of producing properties that may encompass all or parts of several separate accumulations of oil or gas. In some cases, the different producing properties on the lease may have different operators. And, there may be no common ownership among these several producing properties and, therefore, no exchange of operating information such as oil and gas reserves, production, etc., among the various owners.

The multiplicity of producing properties on a single federal lease may come about in a number of ways. Federal leases initially are executed such that there is common lease ownership of the entire federal lease. Frequently, the owner or owners will grant a sub-lease, referred to in the industry as a farmout, for a portion of the lease (either a portion defined by a surface area or by depth intervals of the subsurface). The farmout may be made for any portion of the working interest up to 100% and may be made to a single operator or be subdivided among a group. Unless the original lessee retained a percentage of the "working interest" rights to the portion farmed out, he would not participate in any manner in the exploration, development or production of the area farmed out. In this circumstance, the original lessee has no contractual authority or relationship enabling him to have ready access to information on the producing properties in the area farmed out.

To require the operator of one of the producing properties on a Federal or Indian lease to handle the business affairs of other properties in which he has no interest would place him in a vulnerable and virtually untenable position. Such an operator would have no contractual mechanism for securing needed data and cooperation from other operators and owners, but would be liable for any resultant mispayment of royalties.

Ordinarily each working interest owner within each producing property pays his own royalty and may be unaware of the sales and royalty payment arrangements of the other interest owners. In some instances the operator of a unitized property may disburse the royalty for all of the working interest owners in the unit. However, because of antitrust implications royalty disbursement responsibility is not centralized for a Federal or Indian lease having multiple producing properties with noncommon ownership.

We believe that continuation of the present payor system is in the best interest of all concerned. However, if the Congress decides otherwise, then it would be much more effective from the federal royalty managers viewpoint and much more feasible from the industry's standpoint to assign payor responsibility to the operator of each producing property, rather than to hold one operator responsible for all royalties on the entire Federal or Indian lease. The operator of each producing property has a contractual mechanism, the joint interest agreement, which would enable him to secure needed information from other working interest owners in the property with some degree of assurance that the information can be obtained.

ARCO Oil and Gas Company recommends that the single payor, or operator of record, approach be discarded and that an amended version of the Commission's Internal Controls Recommendation Number 2 (see Attachment II) for both present and future federal leases be adopted. The Commission's recommendation should be amended to require the present operator of each producing property on each existing Federal and Indian lease to provide the Secretary a payor plan identifying the payors for 100% of the royalty obligation on the producing property. A similar payor plan should be required each time a new producing property is formed on a Federal or Indian lease. Finally, each payor should be required to notify the Secretary each time a change in his payor status occurs. As a safeguard the Secretary should be required to acknowledge receipt of the notifications.

The Commission's Internal Controls Recommendation Number 2 as modified would enable the federal royalty managers to establish an internal system within the USGS to permit very tight control over the federal royalty payment process with direct contact between the USGS and the responsible payors on each producing property. By contrast, the single payor concept for each federal lease would in many cases force the federal royalty managers to deal with third parties having no direct involvement in the production and sale of the federal royalty oil and gas.

REFINERY DOCUMENTATION OF ORIGIN OF OIL

The Commission recommended "That the Department seek federal legislation to prohibit the purchase of undocumented crude oil and require purchasers of crude oil up to and including refiners to keep documentation showing from whom they purchased the product and from what lease or unit."

ARCO Oil and Gas Company recognizes the need for proper documentation to establish proof of legitimate purchase and ownership. Documentation in the form of run tickets, transfer documents, crude purchase invoices, etc. which clearly establishes proof of ownership is needed to help deter oil theft from Federal and Indian leases as well as private leases.

However, we are concerned about that portion of the recommendation which would require refiners to document the lease or unit source of their oil purchases. It is generally impossible to accurately establish the lease or unit identity of oil received at refineries due to the physical blending of oil during transportation from the producing field to the refinery. Oils of similar characteristics are batched as they enter the pipeline network and thus lose their identity as to source. Within the pipeline network, to match current refining requirements with crude oil avails and to minimize transportation costs it is quite common for oil to be sold, exchanged, or traded. In fact, the ownership of oil may change several times between the lease and the refinery.

Considering these factors, it is essentially impossible to trace the oil from the refinery gate back to point of origin with any significant degree of accuracy. Only in those cases where oil is trucked directly from lease to refinery would such be possible.

While the legislation does not specifically speak to the Commission's recommendation concerning the tracing of oil from lease to refinery, the record keeping requirements appear sufficiently broad to embrace that recommendation.

FAIR MARKET VALUE

The question of "fair market value" of oil or gas production is extremely complex and does not lend itself to a legislative solution nor a precise definition to be applied in the variety of situations which can arise.

First, many producing properties involve two separate commodities, crude oil and natural gas, and the market place for each is markedly different. Crude oil is usually sold on short-term contracts, with pricing responsive to the spot market. Crude oil is not subject to price controls.

On the other hand, because of the necessity to construct high cost gas gathering systems natural gas is sold under long-term contracts and is and has been for a number of years subject to rigorous price controls. Prior to passage of the Natural Gas Policy Act of 1978 (NGPA) natural gas was sold in two distinctly different markets, the interstate market and the intrastate market. The price of natural gas sold in the interstate market was limited by rates established by the FERC (formerly the Federal Power Commission) whereas natural gas sold in the intrastate market was not subject to this limitation and might be sold at a higher or lower price than that set by the FERC. The NGPA extended the jurisdiction of FERC to intrastate gas sales, but authorized the FERC to prescribe higher ceiling prices for certain categories of high cost natural gas.

Because gas is sold under long-term contract, on the best terms available at the time the contract is entered into, and because of the price distortions created by price controls, two facts emerge. First, rather than there being one market value, there may be numerous market prices, even within the same field, which arise by virtue of FERC classification of the wells from which gas is produced. In other cases the location of a gas source may be such that there is limited demand by gas purchasers. In such cases, a producer simply may not be able to command a price equivalent to the regulated maximum price. In other cases, where there is strong demand for new supplies, the purchaser might be willing to pay FERC maximum or higher prices for unregulated gas.

In another situation, a given producer may be price limited by the terms of his own long-term gas contract, negotiated in good faith several years previously. Many years ago, the FPC declared to be contrary to public policy certain interstate gas sales contract provisions which would result in automatic price increases if the purchaser or some other purchaser in the field or within a defined area paid a higher price for other gas. These so-called favored-nations clauses would have enabled producers to receive and pay to royalty owners as royalty the price currently being offered or paid for other gas supplies. Deprived of these price increase triggering devices, producers were in effect precluded by federal law from complying with their lease terms, i.e., to receive and pay current market value.

While the FPC (now FERC) permitted some very limited forms of price increase clauses in gas sales contracts, these increases and the clauses that permitted such increases in no way tracked the progress of the real value of energy. Even today, the FERC controls the content of gas sales agreements and the basic inconsistencies between the objectives of federal price regulation and federal land management and royalty collection persist. When one considers the market distortions wrought by federal regulation and state law, to require a producer to pay royalty based on some hypothetical market value or price is manifestly unfair. Moreover, if the regulated contract price is sufficiently lower than the hypothetical market value, the lease could be rendered uneconomic, even while producing large quantities of natural gas, and premature abandonment of the property with loss of all future royalty would occur. A combined regulatory/royalty scheme which achieves this result can only be described as a form of inverse condemnation, thereby entitling the producer to compensation for the value of the property so condemned.

A good example of the problem created by trying to legislate market value or establish an arbitrary formula is demonstrated by the recent notice by the Minerals Management Service concerning its proposed "unit value" for OCS natural gas. There, the Minerals Management Service proposes the fair market value of gas qualifying as deep, high cost gas under the NGPA, to be $7.49/Mcf for production beginning in November 1981, or proceeds received by the lessee for such gas, whichever is higher.

This form of regulation amply illustrates the problem of attempting to promulgate a binding definition or formula which does not take into account limitations imposed on producers by federal regulation, current market conditions and binding contract obligations, even though the contracts were entered into in good faith under vastly different market conditions -- at a time when the producer was required to market the gas under the convenants of his lease for the best price obtainable.

To the extent that a producer has contracted for a lesser price than the minimum contained in the Minerals Management Service royalty proposal, he has done so because of some outside force, e.g. current market conditions, existing contract, Federal regulations, etc. Given the alternative, an operator would not sell natural gas below current market value.

Federal regulatory schemes to regulate natural gas prices appear to be designed to provide energy to consumers at the lowest practical price. Congress has legislated a form of regulation which places the public interest paramount to the interest of the lessee. To the extent that the lessee must sell the royalty gas, the logical extension of the Congressional policy is to make the interest of the Department of Interior likewise subservient to the interest of the public. We submit that the federal legislative and regulatory purpose do not authorize or permit the Department to require payments in excess of what the lessee can contractually receive. To declare otherwise, would clearly result in a taking without compensation.

We urge that the Secretary exercise the discretion that he has under existing federal lease forms to determine market value on a case-by-case basis in those situations where a lessee takes all or a portion of its gas in kind for sale to an affiliate or division. It would be appropriate for the Secretary, under published regulations, to consider a reference price, other than proceeds, for royalty computation under such circumstances. The value to be established by the Secretary should be based on sales comparable in quantity, quality and time in the same relevant market. Similarly, if the Secretary determined that a contract to an unaffiliated purchaser involved issues or considerations extraneous to the lease in question, the Secretary could, after notice and hearing, establish a price in excess of the proceeds of the questioned sale. Otherwise, arms-length transactions entered into in good faith should be acepted and respected.

The Department of Interior and its lessees share a common goal, to find domestic natural resources and sell them at market value. When another branch of government intervenes and partially frustrates the objective of DOI and its lessees, both should be equally impacted. To reach a different result would make a mockery of the lease terms.

PENALTIES

The civil and criminal penalty provisions in the proposed legislation appear to represent a radical departure from similar provisions in existing law. For example, Section 106 of H.R. 5121 provides that it will be unlawful for any person to prepare an "inaccurate" report. A similar provision is found in Section 14 of S.2305. Both bills then provide for an automatic civil penalty of $10,000 per day for any noncompliance (including presumably clerical errors resulting in inaccurate reports), subject only to relief in the discretion of the Secretary. In other words, an inaccurate report could be discovered six months after it was submitted, and a penalty assessed at the rate of $10,000 per day for each day during that six-month period, with the burden shifting to the Company to try and convince the agency that the error was innocent or that extenuating circumstances exist.

There is no similar penalty provision in the Mineral Leasing Act of 1920 or laws affecting federal onshore or Indian leases. Contrast the proposed legislation with the present civil penalty provision of the OCSLA. There, in Section 1350, a similar $10,000 per day civil penalty is provided for, but it will be assessed only after notice of failure to comply and the expiration of a reasonable period for corrective action. On the other hand, the severe civil penalty provisions of the proposed legislation are self-executing, even when the error is discovered and rectified by the operator, the only relief being an appeal to the discretion of the Secretary or his representative.

We believe the civil penalty provisions of the legislation should be changed so as to be consistent with those found in the OCS Lands Act as amended, 43 USCLA, Section 1350(b).

With respect to criminal penalties, it is felt that the provision for a $25,000 fine for each day of violation is excessive, when compared with the OCSLA. There, except for violations of regulations designed to protect health, safety or the environment or to conserve natural resources, each day of violation does not constitute a separate offense. Conceivably, the filing of an inaccurate report discovered months after its filing, could result in a grossly disproportionate fine if each day is counted as a separate violation. The proposed legislation should be amended to provide for a maximum fine with respect to violations associated with reporting and recordkeeping (see for example, Section 106(2) of H.R.5121 and Section 14(2) of S.2305) rather than making each day a separate violation. Further, any fines should be levied against the firm rather than against individuals. The daily criminal penalty provision should apply only to the most serious violations in cases where a determination is made of willful and deliberate intent to defraud.

The penalty provision allowing the Secretary authority to subject an operator to forfeiture of the value of total production for failure to notify the Secretary within one day of new production (Sec. 15(b)(2) of S.2305 and Sec. 107(b)(2) of H.R.5121) seems unnecessarily harsh. This could result in forfeiture of thousands of dollars worth of production simply because of difficulty in reporting from a remote location or failure to report through administrative error. Even though resort to this penalty provision rests in the Secretary's discretion, we suggest the treble-royalty forfeiture provision provides far more than adequate incentive to comply with the new production notice requirement.

SITE SECURITY

The Commission's report addressed the problem of site security on Federal and Indian leases especially as it related to theft of crude oil. The Commission concluded that the crude oil theft problem was of a sufficient magnitude to cause substantial losses in Federal and Indian royalties. With tens of thousands of wells on some 17,500 onshore Federal and Indian leases, many of which are in remote and isolated locations, there is little doubt that some crude oil has been stolen.

Before discussing the Commission's recommended remedies to the crude oil theft problem, it would be useful to consider the environment in which the oil and gas industry operates. Oil and gas leases, especially those located on Federal and Indian lands, are generally located in remote regions. Perhaps a majority of Federal and Indian leases are many miles from the nearest dwelling and most are out of sight. This remoteness provides a perfect setting for the theft of crude oil and equipment. Some security measures may reduce theft. However, wells, tank batteries and other oilfield installations are simply too remote for feasible security measures to eliminate theft. Recognizing this reality, ARCO Oil and Gas Company diligently endeavors to implement cost effective security measures which yield reductions in theft losses commensurate with the expense incurred.

We, and producers in general, have a large vested interest in minimizing theft of crude oil and equipment. On a 1/6 royalty Federal lease, producers have an interest in 5/6 of the oil produced from the lease, and therefore experience 5 times as great a loss from theft as does the Government. In attempting to ensure that the theft of crude oil and equipment is minimized, we believe that security measures should be cost effective and tailored to fit the specific sites and circumstances. Thus we do not believe it is appropriate for specific standards to be imposed by the Government. For example, a proposal to require that all hatches on crude oil tanks be locked may not be as effective a deterrent in some cases as it might appear. Because of the remoteness of most tanks, bolt cutters would easily make the lock no deterrent at all. Furthermore, locking the hatches may create safety hazards by negating their value as pressure relief devices.

The legislation being considered in the House and the Senate would require that lessees develop a site security plan in conformance with minimum DOI standards. The Commission's report recommends such a plan, but made two important qualifications with which we concur. First, it rejected the imposition of a "cookbook" approach to security plans -- that is, detailed, stringent and virtually identical requirements for each lease -- as "burdensome, costly, and unenforceable." Second, the Commission made it clear that such plans should generally be designed on a company-wide basis, not for each individual lease. To avoid the potential for excessive and needless regulation if not clarified, the proposed legislation should be amended to make it clear that a security plan is to be developed on a company-wide basis, not for each specific lease.

While reasonable measures for site security are appropriate, it should be recognized that prevention of theft from leases is all but impossible. We believe that crude oil title enforcement is the strongest weapon to reduce oil theft. The Commission's recommendation that truck haulers of crude oil be required to have run tickets in their possession at all times while transporting oil from Federal and Indian leases would be an effective deterrent to crude oil theft if stringently enforced.

Attachment I

DATA CURRENTLY AVAILABLE TO MINERALS MANAGEMENT SERVICE FOR ROYALTY VALIDATION

Monthly Report of Operations - OCS Form 9-152
Onshore Form 9-329
Indian Form 9-329A

- Submitted monthly by each operator
- Reports for each well:
  - Well Number
  - Well Status
  - Days Produced
  - Barrels of Oil Produced
  - MCF of Gas Produced
  - Barrels of Water Produced or Injected
  - Explanation of Why Well Did Not Produce, if Applicable
- Reports in Total:
  - Beginning Inventory of Oil - Barrels
  - Barrels of Oil Produced
  - Barrels of Oil Sold
  - Ending Inventory of Oil - Barrels
  - Oil Gravity
  - MCF of Gas Produced
  - MCF of Gas Sold
  - MCF of Gas Flared or Vented
  - MCF of Gas Used as Fuel on Lease
  - MCF of Gas Injected
  - Other Dispositions of Gas
  - BTU Content of Gas
  - Barrels of Water Produced
  - Barrels of Water Injected

Monthly Report of Sales and Royalty - Form 9-361

- Purchasers Oil Runs Statement
- Purchasers Gas Settlement Statements

Attachment II

FISCAL ACCOUNTABILITY OF THE NATION'S ENERGY RESOURCES

Internal Controls Recommendation No. 2

That the Department immediately require all lessees of revenue producing leases or their agent (the operator or some other agent) to submit a payor plan signed by all payors indicating the payment responsibilities of each party. In the payor plan, the lessee should identify the payors for 100 percent of the royalty obligation. Modified payor plans must be submitted whenever any payor responsibilities change. Upon receiving such changes, the Federal royalty managers should consider them as being proper unless they are later disapproved. Noncompliance with these requirements would subject the lessees to substantial penalties.

Internal Controls Recommendation No. 2 - (as amended)

That the Department immediately require all operators of producing properties on revenue producing leases or their agent to submit a payor plan signed by all payors indicating the payment responsibilities of each party. In the payor plan, the lessee should identify the payors for 100 percent of the royalty obligation. Modified payor plans must be submitted by each payor whenever his payor responsibilities change. Upon receiving such changes, the Federal royalty managers should consider them as being proper unless they are later disapproved. Noncompliance with these requirements would subject the lessees to substantial penalties.

Senator **Wallop**. Mr. H. Pete Smith, who is executive vice president for finance of the Beacon Oil Co. on behalf of the Independent Refiners Association of California—I apologize, Mr. Smith. That was nothing but a Freudian subliminal intention.

Mr. **Smith**. I'm hungry, too, Mr. Chairman, so I will attempt to make this as fast as possible.

Senator **Wallop**. Please don't feel constrained. I really had overlooked you.

STATEMENT OF H. PETE SMITH, VICE PRESIDENT, FINANCE, BEACON OIL CO., ON BEHALF OF THE INDEPENDENT REFINERS ASSOCIATION OF CALIFORNIA

Mr. **Smith**. Mr. Chairman, my name is Pete Smith. I am a vice president of finance for Beacon Oil Co. based in Hanford, Calif. I am appearing today on behalf of Beacon and the Independent Refiners Association of California known as IRAC.

IRAC is an association of 14 west coast——

Senator **Wallop**. I thought that was the way they pronounced it in Texas!

Mr. **Smith**. I believe they do—14 west coast small and independent refiners which have been in existence for over 45 years; 13 of those members are located in California, and one is located in Seattle, Wash.

I am pleased to appear before the committee to summarize our written statement on S. 2305. The committee is to be commended for its expeditious handling of the important issues raised by this legislation and for recognizing that major reform is necessary to insure lawful and efficient management of the royalty oil program in the future.

The focus of my testimony today, however, is not those features of S. 2305 that commend its enactment, but rather with the provision in the bill that would retroactively grant the Department of Interior absolute and unjustified immunity from any liability for apparently willful violations of the DOE mandatory petroleum price regulations in its sales of royalty oil to small refiners.

Buried within S. 2305 is section 12, misleadingly entitled "Secretary's Independent Authority to Collect Royalty." Section 12 represents a transparent attempt by Interior to obtain congressional immunity from actions against it for past overcharges in the sale of crude oil. Section 12 is not based in whole or in part on any of the recommendations of the Linowes Commission, nor does section 12 have anything to do with Interior's continued authority to collect royalties. There are two threshold questions that must be answered to determine whether the USGS should be entitled to the retroactive exemption provided in section 12 of this bill.

First, did Congress intend that the USGS be subject to the Emergency Petroleum Allocation Act and the regulations promulgated thereunder? If so, then the second question is are there compelling circumstances to warrant exempting the USGS from liability for past overcharges in the sale of crude oil?

Let me first address the public record in the area of congressional intent. In 1973 Congress enacted the Emergency Petroleum Allocation Act, EPAA, in response to the OPEC oil embargo. Section

4(a) of that act authorized the President to promulgate regulations providing for the mandatory allocation and pricing of all crude oil with no exception for oil produced and refined by the Federal Government.

One of the primary purposes of this legislation was to insure that small and independent refiners as well as the independent marketers on which they relied did not bear a disproportionate share of the shortages and economic dislocations caused by the embargo. Indeed in enacting the legislation, Congress declared that small refiners were members of a protected class.

After enactment of the EPAA, regulations were implemented that expressly made all governmental entities, including the Federal Government, subject to these price controls. The validity of these regulations was subsequently confirmed by the temporary emergency court of appeals in *California* v. *Simon*. Moreover, the applicability of the mandatory petroleum price regulations to the Federal Government, including DOI, was repeatedly stated in public pronouncements of the DOE and its predecessors. We have attached to our written statement a memo evidencing a meeting of the officials from the Interior Department and the DOE to discuss USGS apparent noncompliance with DOE price regulations.

DOE's record of that meeting unequivocally demonstrates that USGS knew it was charging prices for crude oil that exceeded DOE's regulations and that DOE again informed USGS that it must comply with DOE's rules.

Subsequently Congress itself removed any remaining doubt about DOE's authority to regulate the prices charged by Interior for Federal royalty oil. In the Department of Energy Organization Act, Congress transferred from the Secretary of the Interior to the Secretary of Energy the authority to promulgate regulations governing the procedures, terms, and conditions for acquisition and disposition of Federal royalty oil taken in kind. Moreover, in the following year, Congress enacted the Outer Continental Shelf Lands Act Amendment of 1978 which specifically provided that the Secretary of Interior's authority to dispose of Federal royalty oil must be in accordance with price regulations promulgated by the Secretary of Energy. I think this can lay to rest any assertion that Congress did not intend that the USGS be subject to mandatory control and price regulations under EPAA.

I would now like to review the basis asserted by USGS to support the immunity it seeks in section 12 of S. 2305. If I understand the position of the USGS correctly, they assert two principal justifications for amnesty.

First, incredibly the USGS suggests that Congress did not provide the staff or the budget necessary to monitor properly the compliance of lessees' production reports.

Second, the USGS seeks to blame the major oil companies for failing to provide USGS with the information necessary for certifications that USGS was required to make under the DOE rules in a timely fashion in order to collect the highest lawful price. In effect, USGS represents itself as an innocent bystander.

Neither excuse offered by USGS constitutes a compelling circumstance justifying retroactive exemption from the price controls. USGS' claim that it lacked the staff or budget to comply with the

DOE price rules for crude oil has a hollow ring. The agency's own internal documents demonstrate that USGS could have complied with the price regulations but chose not to do so. In a memo as early as April 16, 1976, the head of the Conservation Division admitted that USGS' administrative charges, transportation charges, and other additions to DOE's ceiling price were illegal under DOE rules. Significantly, the Director asked whether USGS must comply with these rules so that appropriate accounting changes could be implemented. The memo, a copy of which we have attached to our written statement, demonstrates that USGS lacked only the will to comply with the rules, not the resources to do so.

USGS' belated claim that the agency's pricing errors resulted from problems caused by major oil companies is equally unconvincing. In the first place, only a fraction of USGS' pricing violations were due to late certifications. Most of the violations involved illegal surcharges tacked on to lawful ceiling prices. For example, in the case of my company, Beacon Oil, we estimate that only about 20 percent of the overcharges involved a certification problem.

Consequently, USGS is not the innocent bystander it pretends to be.

More fundamentally, USGS' pretended ignorance is not an excuse for willfully ignoring the law. Many other producers face the same kind of information lag allegedly faced by USGS. Nonetheless, these other companies, including many other governmental bodies, were able to comply with the certification provisions of the regulation. In short, USGS' alleged problems were hardly unique, and certainly don't constitute a reason for extracting price overcharges from the protected class of small refiners.

USGS does not need this litigation to vindicate any defenses it might have to the overcharge suits. Congress has required DOE to establish an exceptions process that can grant USGS any retroactive relief it deserves. In addition, the Federal courts can be trusted to protect USGS' rights and insure the fairness of DOE's exception process. The complex factual and legal issues raised by USGS' purported defenses to its price violations should not be litigated in Congress. Rather USGS should first exhaust the administrative and judicial remedies which are available to all participants in DOE's programs.

This Congress has repeatedly received assurances from the President that his administration will rigorously enforce past price regulations with no amnesty for overcharges. To exempt Interior from overcharge actions while leaving other governmental entities and private producers of crude oil subject to such actions is inherently unfair and sets a questionable precedent.

Moreover, Mr. Chairman, the burden of exempting USGS from liability for overcharges falls most heavily on the small refiners whose size and need for crude oil left them with no choice but to yield to DOI's demand for unlawful prices. The enactment of section 12 will injure small refiners, independent marketers, and their ultimate consumer customers. These are the very persons that Congress sought to protect when it enacted the EPAA. By precluding small refiners from bringing lawsuits to recover overcharges from USGS, section 12 damages their competitive viability in comparison to refiners who receive their oil from other sources and were not overcharged.

Such a result is contrary to one of the primary purposes of the EPAA—the preservation of the competitive viability of small and independent refiners. The effect of section 12 is also contrary to the purpose of the provisions of the Outer Continental Shelf Lands Act, specifying the sale of royalty oil to small refiners at competitive prices. Thus section 12 has the effect of denying benefit to small refiners that Congress clearly intended them to have. It is extremely unwise to grant retroactive relief to an agency which for years has knowingly flaunted regulations applicable to it. Such a precedent would make the Department of Interior and other agencies less vigilant in their adherence to other laws.

In this regard, I must point out that section 12 flouts the announced purpose of S. 2305, to correct the Interior's prior mismanagement in administering the Federal royalty oil programs as pointed out by the Linowes Commission. To my mind, you do not correct and improve misconduct by rewarding it.

It is a sad irony that the DOI should propose at the same time legislation to insure the lawful and efficient management of the royalty oil program and legislation requesting immunity from the excesses and inefficiencies of their past performance.

I urge that the committee reject the amnesty that the Department of Interior requests by eliminating section 12 from S. 2305.

Thank you, Mr. Chairman. I would be happy to answer any questions if you have any.

[The prepared statement of Mr. Smith follows:]

STATEMENT

OF

H. PETE SMITH

ON BEHALF OF

BEACON OIL COMPANY AND THE

INDEPENDENT REFINERS ASSOCIATION OF CALIFORNIA

BEFORE THE

SENATE ENERGY AND NATURAL RESOURCES COMMITTEE

CONCERNING

S. 2305, THE "FEDERAL ENERGY
AND MINERAL RESOURCES ACT OF 1982"

ON

May 3, 1982

Mr. Chairman, my name is H. Pete Smith, and I am Vice President for Finance of the Beacon Oil Company based in Hanford, California. I am appearing today on behalf of Beacon and the Independent Refiners Association of California (IRAC).

IRAC is an association of fourteen West Coast small and independent refiners which has been in existence for forty-five years. Thirteen of our members are located in California and one is located in Seattle, Washington.

Mr. Chairman, I am pleased to appear before this Committee to testify on S. 2305, the "Federal Energy and Mineral Resources Act of 1982." Most of the provisions of this legislation are based on recommendations emerging from the extensive investigation recently conducted by the Commission on Fiscal Accountability of the Nation's Energy Resources, more commonly known as the Linowes Commission. S. 2305, prepared by the DOI in response to the recommendations of the Linowes Commission, seeks to eliminate problems that plague DOI's federal royalty oil program.

This Committee is to be commended for its expeditious handling of the important issues raised by this legislation and for recognizing that major reform is necessary to ensure lawful and efficient management of the royalty oil program in the future.

The focus of my testimony today, however, is not those features of S. 2305 that commend its enactment, but rather with a provision in this bill that would retroactively grant the Department of Interior absolute and unjustified immunity from any liability for apparently willful violations of the DOE Mandatory Petroleum Price Regulations in its sales of royalty oil to small refiners.

Buried within S. 2305 is Section 12, misleadingly entitled "Secretary's Independent Authority to Collect Royalty." Section 12 represents a transparent attempt by DOI to obtain congressional immunity from actions against it for past overcharges in the sale of crude oil.

Section 12 is not based in whole or in part on any of the recommendations of the Linowes Commission. Nor does Section 12 have anything to do with DOI's continued authority to collect royalties. In fact, Mr. Chairman, I would venture to guess that if any producer or refiner of crude oil, other than an organ of the federal government, proposed to a member of this Committee that he be granted retroactive immunity or "amnesty" from liability for price overcharges on the same basis that the USGS asserts, he would not even be granted a hearing by this Committee.

There are two threshold questions that must be answered to determine whether the USGS should be entitled to the retroactive exemption provided in Section 12 of this bill. First, did Congress intend that the USGS be subject to the Emergency Petroleum Allocation Act and the regulations promulgated thereunder? If so, then the second question is, are there compelling circumstances to warrant exempting the USGS from liability for past overcharges in the sale of crude oil? Let me first address the public record in the area of congressional intent.

In 1973 Congress enacted the Emergency Petroleum Allocation Act (EPAA) in response to the OPEC oil embargo. Section 4(a)[1/] of the EPAA authorized the President to promulgate regulations providing for the mandatory allocation and pricing of all crude oil, with no exception for crude oil produced and refined by the federal government. One of the primary purposes of this legislation was to insure that small and independent refiners, as well as the independent marketers on which they relied, did not bear a disproportionate share of the shortages and economic dislocations caused by the embargo. Indeed, in enacting this legislation, Congress declared that small refiners were members of a "protected class."[2/]

After enactment of the EPAA, regulations were implemented that expressly made all governmental entities, including the federal government, subject to these price controls. In relevant part, the regulations stated:

> The prices charged for any sale of a covered product by any Federal department, agency or

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[1/] 15 U.S.C. § 753(a).

[2/] Conf. Rep. No. 628, 93d Cong., 1st Sess., reprinted in 1973 U.S. Code Cong. & Ad. News 2582, 2693.

> other instrumentality . . . are subject to the price regulations of this part . . . [1]

The validity of this regulation was subsequently confirmed by the Temporary Emergency Court of Appeals in California v. Simon.[2]

Moreover, the applicability of the Mandatory Petroleum Price Regulations to the federal government, including DOI, was repeatedly stated in public pronouncements of the DOE and its predecessors. In a decision and order issued to USGS, FEA expressly held that its Mandatory Petroleum Price Regulations were applicable to USGS and superseded any conflicting regulations of USGS or DOI.[3] Shortly thereafter, officials from the Interior Department met with officials of DOE to discuss USGS's apparent non-compliance with DOE price regulations. DOE's record of that meeting unequivocally demonstrates that USGS knew it was charging prices for crude oil that exceeded DOE's regulations and that DOE again informed USGS that it must comply with DOE's rules.[4]

Subsequently, Congress itself removed any remaining doubt about DOE's authority to regulate the prices charged by DOI for federal royalty oil. In the Department of Energy Organization Act, Congress transferred from the Secretary of Interior to the

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[1] 10 C.F.R. § 212.52.

[2] 504 F.2d 430, cert. denied, 419 U.S. 1021 (1974).

[3] United States Geological Survey, 5 FEA ¶ 80,537 (January 26, 1977).

[4] Internal DOE memorandum from Carl A. Corrallo (May 5, 1977) (discussing meeting with USGS representatives) (attached as Exhibit A).

Secretary of Energy the authority to promulgate regulations governing the procedures, terms and conditions for acquisition and disposition of federal royalty oil taken in kind.[1/]

Moreover, in the following year, Congress enacted the Outer Continental Shelf Lands Act Amendment of 1978 which specifically provided that the Secretary of Interior's authority to dispose of federal royalty oil must be in accordance with price regulations promulgated by the Secretary of Energy.[2/]

Thus, Mr. Chairman, we can lay to rest any assertion that Congress did not intend that the USGS be subject to the Mandatory Petroleum Price Regulations under the EPAA.

I would now like to review the basis asserted by USGS to support the immunity it seeks in Section 12 of S. 2305. If I understand the position of the USGS correctly, they assert two principal justifications for amnesty. First, incredibly, the USGS suggests that Congress did not provide the staff or budget necessary to monitor properly the compliance of lessees' production reports.

Second, the USGS seeks to blame the major oil companies for failing to provide USGS with the information necessary for certifications that USGS was required to make under the DOE rules in a timely fashion in order to collect the highest lawful price. In effect, the USGS presents itself as an "innocent bystander" whose

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[1/] 42 U.S.C. § 7152(b).

[2/] 43 U.S.C. § 1353(b)(1) and (3).

failure to certify timely or properly resulted in the sale of oil being automatically deemed as lower tier oil.

Neither excuse offered by USGS constitutes a compelling circumstance justifying retroactive exemption from the price controls. USGS's claim that it lacked the staff or budget to comply with the DOE price rules for crude oil has a very hollow ring. The agency's own internal documents demonstrate that USGS could have complied with the price regulations but chose not to comply. Indeed, in a memo as early as April 16, 1976,[1/] the head of the Conservation Division admitted that USGS's administrative charges, transportation charges, and other additions to DOE's ceiling price were illegal under DOE rules. Significantly, the Director asked whether USGS must comply with these DOE rules so that appropriate accounting changes could be implemented. The memo demonstrates that USGS lacked only the will to comply with these rules -- not the resources.

USGS's belated claim that the agency's pricing errors resulted from problems caused by the major oil companies is equally unconvincing. In the first place, only a fraction of USGS's pricing violations were due to late certifications. Most of the violations involved illegal surcharges tacked onto the lawful ceiling price.

[1/] Internal DOI memoranda from the Chief of the Conservation Division to the Assistant Solicitor of the Minerals Division of Energy and Resources (April 16, 1976) (discussing the conflict between Federal Energy Administration and Department of Interior regulations regarding oil and condensate prices) (attached as Exhibit B).

For example, in the case of Beacon Oil Company, we estimate that only about 20 percent of the overcharges involve a certification problem. Consequently, USGS was not the innocent bystander it pretends to be.

More fundamentally, USGS's pretended ignorance is not an excuse for the law. Many other producers faced the same kind of information lag allegedly faced by USGS. Nonetheless, these other companies, including many other governmental bodies, were able to comply with the certification provisions of the regulation. In short, USGS's alleged problems were hardly unique and certainly don't constitute a reason for extracting price overcharges from the "protected class" of small refiners.

In any event, USGS certainly does not need this legislation to vindicate any defenses it may have to the overcharge suits. Congress has required DOE to establish an exceptions process that can grant USGS any retroactive relief it deserves. In addition, the federal courts can be trusted to protect USGS's rights and insure the fairness of DOE's exception process. Under these circumstances, the complex factual and legal issues raised by USGS's purported defenses to its price violations should not be litigated in Congress. Rather, USGS should first exhaust the administrative and judicial remedies which are available to all participants in DOE's programs.

Apart from the fact that USGS can point to no compelling circumstances to justify the amnesty that it seeks, the retroactive elimination of all DOI accountability for past overcharges also would be inequitable and unwise.

This Congress has repeatedly received assurances from the President that his Administration will rigorously enforce past price regulations with no amnesty for overcharges. The DOI is one of the largest producers of crude oil, administering interests in vast oil and gas properties owned by the United States onshore and on the Outer Continental Shelf. To exempt DOI from overcharge actions, while leaving private producers of crude oil subject to such actions, is inherently unfair and sets a questionable precedent.

Nor does DOI's status as a governmental entity warrant the granting of immunity from overcharge actions. The crude oil price and allocation controls provided in the EPAA and other federal statutes apply to other government entities as well, such as the States of Texas and Louisiana and the City of Long Beach. USGS has failed to demonstrate why it should be treated differently from these other governmental entities and receive a special retroactive exemption from liability for overcharges.

Mr. Chairman, this Committee can be sure that if the USGS is granted the exemption provided in Section 12, it will not be long before these other entities petition this Committee for similar retroactive relief.

I ask this Committee the simple question: Where do you draw the line? If Section 12 is enacted, every major economic interest subject to the EPAA will look to Congress as the "court of last resort." I doubt seriously that this Committee would want to encourage the flood of special requests that would be sure to follow.

Moreover, Mr. Chairman, the burden of exempting the USGS from liability for overcharges falls most heavily on the small refiners, whose size and need for crude oil left them with no choice but to yield to DOI's demands for unlawful prices.

Enactment of Section 12 will injure small refiners, independent marketers and their ultimate consumers. These are the very persons that Congress sought to protect when it enacted the EPAA. By precluding small refiners from bringing lawsuits to recover overcharges from USGS, Section 12 damages their competitive viability in comparison to refiners who were not overcharged. Such a result, Mr. Chairman, is contrary to one of the primary purposes of the EPAA — the preservation of the competitive viability of small and independent refiners.

The effect of Section 12 is also contrary to the purpose of the provisions in the Outer Continental Shelf Lands Act, specifying the sale of royalty oil to small refiners where adequate supplies of crude oil are not available to small refiners in the open market at competitive prices. Thus, Section 12 has the effect of denying a benefit to small refiners that Congress clearly intended them to have.

Mr. Chairman, Section 12 also sends the wrong signal to DOI. It obscures the intention of Congress with respect to the obligation of USGS to comply with other energy statutes. For example, USGS has periodically maintained that it is not subject to the windfall profit tax. If Congress enacts Section 12, it does not require the prophetic powers of Isaiah to see the time when the USGS will come again before Congress to request an additional exemption from its obligations under the windfall profit tax.

Further, it is extremely unwise to grant retroactive relief to an agency which for years has knowingly flaunted regulations applicable to it. Such a precedent would make DOI and other agencies less vigilant in their adherence to other laws. In fact, I believe it is fair to say that the enactment of Section 12 would undermine the importance, in the minds of the general public, of strict adherence to the laws that the Congress enacts in the energy area.

Finally, Mr. Chairman, I must point out that Section 12 flouts the announced purpose of S. 2305 to correct DOI's prior mismanagement in administering the federal royalty oil programs as pointed out by the Linowes Commission. To my mind, you do not correct and improve misconduct by rewarding it.

It is a sad irony that the DOI should propose at the same time legislation to ensure the lawful and efficient management of the royalty oil program while requesting immunity from the excesses and inefficiencies of their past performance.

Mr. Chairman, I urge you to reject the amnesty that DOI requests by eliminating Section 12 from the balance of S. 2305.

Thank you.

EXHIBIT A

May 5, 1977 PR 7

MEMORANDUM FOR THE FILE

FROM: Carl A. Corrallo

SUBJECT: Meeting With U.S. Geological Survey Representatives

On May 2, 1977, Paul Bloom, Deputy General Counsel, and I met with representatives of the United States Geological Survey, including Ms. Karen A. Shaffer, a senior attorney from the Department of Interior, Office of the Solicitor. The meeting was called by Mr. Bloom to discuss the intentions of the U.S. Geological Survey and the Department of Interior with respect to their compliance with FEA regulations in the sale of royalty crude oil produced on leases owned by the federal government. Mr. Bloom explained to the U.S.G.S. representatives that certain information regarding U.S.G.S. had come to our attention by way of audits and investigation conducted by Region VI personnel in Louisiana and Texas and by way of U.S.G.S. involvement in the exceptions and appeals procedures associated with the payment of royalties to U.S.G.S. That information suggests that U.S.G.S. either did not consider itself to be subject to the jurisdiction of the Federal Energy Administration regulations or was disregarding the requirements of those regulations.

Specifically I pointed out that in sales of crude oil by U.S.G.S., the prices charged were in excess of the ceiling price. This was the result of U.S.G.S. calculating the price for such crude oil by reference to the average prices charged by the operator of the property from which the crude oil was produced and then adding a 1/2 percent fee to cover both transportation and administrative costs incurred in such sales. Further, notwithstanding our regulatory requirements that sellers of crude oil certify whether such crude oil is upper tier or lower tier crude oil, U.S.G.S. was providing estimates of the mix of the crude oil they sold by reference to the mix of the property from which it was produced, without regard to any determination as to the classification of the particular crude oil being sold. In some cases, U.S.G.S. was providing no certifications at all. These violations appeared to be clear cut and extremently troublesome to FEA, given our mandate from the Congress to impose regulations on all crude oil produced in or imported into the United States.

Ms. Shaffer and U.S.G.S. representatives suggested that the mandate of the statute which provided the Secretary of Interior with the authority to administer federal oil leases clearly required that crude oil produced from such leases be "valued" with respect to the market prices and also required the recovery of certain administrative costs associated with the sale of such crude oil. They advised that U.S.G.S. took crude oil in kind to satisfy its royalty interests, although such transactions were on paper only, i.e. U.S.G.S. never took physical possession of the crude oil. In other circumstances, the operator merely pays U.S.G.S. a sum representing a 1/6 interest in the total proceeds received in the sale of the crude oil produced from the property.

U.S.G.S. suggested that this statutory authority of the Secretary of Interior displaced or superseded the authority vested in the President and the Administrator of the FEA by the Emergency Petroleum Allocation Act. Mr. Bloom and I took exception to this reading of the statute and indeed indicated quite strongly that it was our view that the Allocation Act imposed a requirement on the administration of these federal leases to conform with FEA regulations. We suggested that the distinction between the U.S.G.S. taking crude oil in kind as opposed to receiving a royalty interest payment was a meaningless one for the purposes of our regulations. Ms. Shaffer disagreed. She pointed out that, in the case of the operator who had received exception relief in the form of permission to certify certain volumes of lower tier oil as upper tier oil in order to garner sufficient revenues to economically maintain the operation, the statute and regulation required that operator to pay a portion of that increased revenue to the U.S.G.S. as royalty interest owner. This was notwithstanding that the exception relief afforded specifically excluded the royalty interest owners from participation in this relief. Ms. Shaffer was somewhat more hard pressed to justify her position with respect to U.S.G.S.'s sales of crude oil to third parties and indicated that she, after conversations with the other representatives, would reconsider the U.S.G.S. position with respect to FEA regulations and advise us of their decision. It was discussed and contemplated that this decision might eventually be made at a substantially higher level within both our organizations before the conflict could be completely and satisfactorily resolved.

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EXHIBIT B

APR 19 1976

Memorandum

To: Assistant Solicitor—Minerals
Division of Energy and Resources

From: Chief, Conservation Division

Subject: Conflict Between Federal Energy Administration (FEA) and Department of the Interior (DOI) Regulations Regarding Oil and Condensate Prices

By Memorandum of March 17 (copy enclosed) from our Metairie office, we were advised of an apparent conflict between the FEA regulations (10 CFR 212.52) and DOI regulations (30 CFR 250.64) regarding oil and condensate prices. Enclosed for your convenience is a copy of the Federal Register of February 3, 1976, that includes 10 CFR 212.52 on page number 4939 and an EXHIBIT I that shows 212.52 (FEA), 250.64, and 221.47 (DOI) relative to the value basis for computing royalties.

The second sentence of both the offshore (30 CFR 250.64) and the onshore (30 CFR 221.47) regulations state "Under no circumstances shall the value of production of any of said substances for the purpose of computing royalty be deemed to be less than the gross proceeds accruing to the lessee from the sale thereof or less than the value computed on such reasonable unit value as shall have been determined by the Secretary." The FEA regulations, 10 CFR 212.52, state that the prices charged for any sale of a covered product by any Federal department or agency are subject to the price regulations herein.

Are we now prohibited from calculating royalties on the gross proceeds accruing to the lease should that value exceed the FEA regulations? In order for us to carry out our responsibilities in accordance with the regulations, we need your immediate legal advice.

The following pertains to some of the problems involved in computing royalties on prices that exceed FEA regulations, retroactive adjustments, etc.:

A. According to the memorandum of March 17 from the Oil and Gas Supervisor, most commingling approvals have been written establishing a value in excess of the posted prices (in most cases by adding a gathering allowance). The current price bulletins for the Gulf of Mexico Area show the oil prices as $5.35 for old oil and $11.53 for new oil, effective February 1, 1976, which are in accord with FEA regulations. Enclosed is the February 1976 Lessee's Monthly Report of Sales and Royalty for lease No. OCS-G-1449 that shows the lessee reported an old oil price of $5.33 per barrel and a new oil price of $11.51 ($5.33 plus $6.18) per barrel. The report also shows a gathering allowance (additional payment) of $0.055 per barrel and a transportation allowance of $0.079826 per barrel. Under the Royalty Quantity column, the report shows that 65,482.32 royalty barrels are taken in kind and sold under royalty oil contract and 2,086.47 royalty barrels are paid for by the lessee. For the royalty oil taken in kind, no transportation allowance is granted because the point of delivery is at the lease, and we have billed the royalty oil refiner at $5.385 ($5.33 plus $0.055) per barrel or $0.035 ($5.385 minus $5.350) per barrel in excess of that permitted by FEA. Also, we have billed the royalty oil refiner at $11.565 ($11.51 plus $0.055 gathering allowance) for the new oil per barrel or $0.035 ($11.565 minus $11.53) per barrel in excess of that permitted by FEA. The lessee's billing is in effect the same as for the royalty oil contract, except the transportation allowance of $0.079826 reduces the price to $5.305174 for old oil and $11.485174 for new oil, neither of which exceeds the prices allowed by FEA regulations. The fact that royalties are being paid by the lessee on a price less than the maximum set by FEA, due to a transportation allowance, does not preclude us from being in violation of the FEA regulations.

Also enclosed are two actual "Summary of Deliveries" from Placid Oil Company to our Metairie office for February 1976. One is for Eugene Island Blocks 296 and 306 that shows the calculation of the oil and condensate net price as $11.7507 ($11.7079 gross price) per barrel for lease Nos. OCS-G-2105 and 2109. This amounts to $0.2207 per barrel more than permitted by the FEA regulations, and oil from lease No. OCS-G-2105 is sold under royalty oil contract. The other summary is for South Marsh Island Field 269 and shows an average net price calculation of $11.7398 ($11.5863 gross

Best Available Copy

price) per barrel applicable to lease Nos. OCS-G-2310, 2311, and 2600. This amounts to $0.2098 per barrel more than permitted by FEA regulations. Said increases are due to pipeline tariff, transportation allowance, and the GRAVCAP ADJUSTMENT for gravity and sulfur.

B. FEA regulations (page 4940) part 212.72, paragraphs (2) and (3) with respect to new crude oil state:

"(2) Effective February 1, 1976, the total number of barrels of domestic crude oil produced and sold in a specific month, less (A) the property's base production control level for that month and less (B) the current cumulative deficiency since February 1, 1976; and

(3) Shall not in either period include any number of barrels not certified as new crude oil pursuant to the provisions of part 212.131(a)(1) within the consecutive two-month period immediately succeeding the month in which the crude oil is produced and sold, except where such recertification is explicitly required or permitted by FEA order, interpretation, or ruling."

Pages 4940 and 4941, part 212.74, paragraph (d) states as to retroactive increase in price that "No producer may charge or accept a retroactive increase in price for crude oil. Retroactive increase in price means any price charged or offered after the close of the calendar month in excess of the highest price prevailing for that grade of crude oil, in first sales between the producer and the purchaser of the domestic crude oil, during the calendar month in which it was produced and sold."

Enclosed is a copy of a letter dated March 18, 1976, from Standard Oil of California to our Alaska office, which shows retroactive changes in royalties due to a change in classification of oil from "old" to "new." This does not necessarily reflect a retroactive increase in price. Also enclosed is a copy of a letter dated March 5, 1976, from Mohawk Petroleum Corporation to our Alaska office, objecting to retroactive adjustments under their royalty oil contract and quoting the FEA regulations. The Alaska office has advised us that this matter with Mohawk has been resolved. We believe that most of our problems with prices and retroactive adjustments will be with the royalty oil purchasers. For example, transporation costs per barrel are determined from cost statements in a large number of cases after the total costs are determined for the calendar year. This requires retroactive adjustments to the value basis on which royalties are computed, and if the transportation costs are less than that previously allowed, we could be calculating royalties on a price in excess of the price allowed by FEA.

C. 30 CFR, part 225.a3, states that a charge for cost of administration of an account equal to one-half percent of the market price will be made for each barrel of OCS royalty oil sold. We have been advised by an FEA auditor, that has been working in our Metairie office, that FEA considers the one-half percent additional charge as an increase in the price of oil under our royalty oil contracts, which may be in excess of the posted prices allowed by the current FEA regulations. The FEA auditor plans to make a report to FEA thereon.

D. To assist you in your review, some other information regarding the value basis for computing royalties follow and are enclosed for your ready reference:

1. Conservation Division Manual, Onshore Oil and Gas, Product Value - Oil and Condensate, dated May 17, 1974.
2. Director's Decision GS-60-O&G, dated October 11, 1974
3. NOTICE to Lessees and Operators from the Tulsa Oil and Gas Supervisor, dated November 12, 1973.
4. Memorandum dated October 31, 1973, to the Conservation Managers, along with the Solicitor's memorandum of August 8, 1973.
5. IBLA 70-123 Decision of July 18, 1973.
6. Director's Decision GS-50-O&G, dated October 27, 1972.
7. Director's Decision GS-48-O&G, dated November 8, 1971.
8. Director's Decision GS-43-O&G, dated August 10, 1971.
9. Page from Mr. Dole's letter of January 26, 1971, to Mr. John Whittier of White House.
10. Letter of May 6, 1969, to Union Producing Company from Tulsa Oil and Gas Supervisor pertaining to tax reimbursement as being part of the gross proceeds.

11. Memorandum of October 7, 1965, to Tulsa Oil and Gas Supervisor from Chief, Branch of Oil and Gas Operations, with a subject "Tax reimbursements as an item comprising gross proceeds in sale of gas."

12. Solicitor's Decision A-29460, dated August 2, 1963.

13. Letter of February 8, 1963, to Honorable Bob Dole from Director.

14. Memorandum of November 8, 1961, to Tulsa Oil and Gas Supervisor from Chief, Branch of Oil and Gas Operations, together with incoming correspondence.

15. Old Branch of O&G Operations Manual, Chapter 3.1A(847), dated March 31, 1961.

16. Director's Decision GS-22-O&G, dated May 20, 1957.

17. Memorandum of July 11, 1956, to Tulsa Oil and Gas Supervisor from Chief, Oil and Gas Leasing Branch.

18. Memorandum to Director, dated June 19, 1956, from Associate Solicitor.

19. Director's Decision GS-18-O&G, dated December 18, 1954.

20. Letter of July 26, 1941, from Acting Chief, Oil and Gas Leasing Division.

According to our Metairie office, a large number of lessees, operators, and royalty oil purchasers are paying royalties on prices that exceed the posted prices allowed by FEA regulations. We do not plan to change our billing procedures until advised by your office on the foregoing.

RUSSELL G. WAYLAND

Chief, Conservation Division

Enclosures

Senator WALLOP. Thank you, Mr. Chairman. IRAC and Beacon Oil were part of that group which Congress designated as a special class; is that right?

Mr. SMITH. Yes.

Senator WALLOP. Anything else we can do for you?

Mr. SMITH. That's all for today.

Senator WALLOP. It doesn't seem to me that you doubt being a protected class by virtue of preceding events. I guess it is your contention, as it is mine, that enactment of section 12 is a constitutional infringement on the rights basically vested not only by statutory law but by constitutional practice?

Mr. SMITH. I am not an attorney, Mr. Chairman, but I think in equity that sounds very reasonable to me.

Senator WALLOP. Neither am I. I guess my point is that these events took place under a prior administration. There is no reason for this administration to seek to absolve others from what they have done, and I know that it is a time of tight budget, but the Republican administrations or Democratic administrations I don't see making it up at the expense of equity under the law, and I think that is what is attempted.

I was a little disappointed in Assistant Secretary Pendley's testimony this morning as to that effect. I am sure we will look at it very closely. Also again I apologize for having overlooked you on the bottom of the list.

Now having perused the list one last time and finding that it is indeed come to an end, we will adjourn this committee subject to the call of the Chair.

[Whereupon, at 12:45 p.m., the committee adjourned subject to the call of the Chair.]

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FEDERAL ENERGY AND MINERAL RESOURCES ACT OF 1982

MONDAY, MAY 17, 1982

U.S. SENATE,
COMMITTEE ON ENERGY AND NATURAL RESOURCES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 3110, Dirksen Senate Office Building, Hon. James A. McClure, chairman, presiding.

Present: Senators McClure and Melcher.

Also present: Gary Ellsworth, counsel; Tony Bevinetto, professional staff member; Terri Sneider, counsel; D. Michael Harvey, chief counsel for the minority; and Craig Gannett, counsel for the minority.

OPENING STATEMENT OF HON. JAMES A. McCLURE, A U.S. SENATOR FROM THE STATE OF IDAHO

The **CHAIRMAN**. Good morning. Today the committee is conducting a second day of legislative hearings on S. 2305, a bill to improve the collection of royalties on Federal energy and mineral resources. I will keep my remarks very brief this morning, but I would like to thank the Department for its prompt response to this hearing on short notice and would particularly note the committee's appreciation of the presence of employees of the Department who have come from outside the Washington area.

The purpose of today's hearing is to receive testimony and answers to questions raised by members of the committee with regard to S. 2305, including my friend from Montana, Senator Melcher, who has been a strong advocate of improved royalty collection.

Appearing before the committee today is Under Secretary Hodel, accompanied by several key departmental staff involved in the formulation of S. 2305.

Mr. Hodel, it is my pleasure to once again welcome you to this committee.

Before we begin with your testimony, I will defer to any members of the committee who wish to make opening statements.

STATEMENT OF HON. JOHN MELCHER, A U.S. SENATOR FROM THE STATE OF MONTANA

Senator **MELCHER**. Thank you very much, Mr. Chairman. I am delighted that this additional hearing was called, because I think it is necessary that we review some of the provisions that are in S.

2305 and try to simplify what is being proposed here, because it gets rather complicated.

It seems to me that much of what is contained in S. 2305 is already existing law. However, there may be points that this administration feels are necessary to emphasize or to restate and I am anxious to hear what that accomplishes.

I see that we have quite a few existing regulations that stem from existing statutes. What we have noted over the past 2½ years has been that the USGS regulations have rarely been enforced in a uniform and conscientious matter by the field staff. And that is one of the principal reasons why I have asked George Campbell and Roy Harrison to be present. As members of the special team that was put together to review the existing practices on Indian and Federal leases throughout the country, they have had the first row seat to see that there is not any uniformity from one region to another in the country and, of course, in the USGS regulations themselves.

Now, that, above all, has to be corrected. Because if we cannot start with a proper procedure to account for the production at the wellhead, whether it is oil or gas, then all that follows is questionable. The accounting procedures must start at the wellhead to determine exactly what is produced, because that is the real key in determining how much royalty is going to be paid.

So that is a problem that I don't know how to solve at all. As to the administration's bill S. 2305, we are up against a time constraint if this bill has some budgetary impact. If it does, it should be reported out of this committee and out of the Indian Affairs Committee prior to May 31. I believe that is the deadline, having been extended from May 15 to the end of the month.

Nevertheless, unless we can get a good piece of legislation to recommend out of these two committees, I would suggest that the proper course would be to admit that we cannot do a proper job in that length of time and that we will ask for a budget waiver whenever the bill is ready.

There are all sorts of objections to the bill, as noted by our committee staff on the Indian Affairs Committee, and the objections come from both the producers and the owners of the oil. So there is a lot of work to be done in that regard.

Second, another question has arisen just in the past few days, that is: I understand that Amoco's and Sohio's leases on the Wind River Reservation in Wyoming have been ordered to be vacated. That makes it all the more important that we get a good bill and a sound bill to the Senate floor.

I will note that, to my knowledge, this is the first time an oil and gas lease has been canceled on an Indian reservation. I take it that the order to vacate is tantamount to canceling the lease, but Mr. Hodel can explain that to us more fully.

Thank you very much, Mr. Chairman.

The CHAIRMAN. Thank you, Senator. Mr. Secretary, would you come to the witness table with whomever will come with you.

STATEMENT OF DONALD P. HODEL, UNDER SECRETARY, DEPARTMENT OF THE INTERIOR, ACCOMPANIED BY WILLIAM P. PENDLEY, DEPUTY ASSISTANT SECRETARY FOR ENERGY AND MINERALS; ALEXANDER H. GOOD, ASSOCIATE SOLICITOR, ENERGY AND RESOURCES; EDDIE R. WYATT, ACTING ONSHORE MINERALS MANAGEMENT CHIEF; GEORGE CAMPBELL, SUPERVISORY PETROLEUM ENGINEERING TECHNICIAN; ROY HARRISON, PETROLEUM ENGINEERING TECHNICIAN; JANE P. LYDER, ASSISTANT LEGISLATIVE COUNSEL; AND MILO MASON, ATTORNEY, ENERGY AND RESOURCES DIVISION, OFFICE OF THE SOLICITOR

Mr. **Hodel**. Thank you, Mr. Chairman and Senator Melcher. I have asked to have with me today William Pendley, who is the Deputy Assistant Secretary for Energy and Minerals, and has had a close working involvement with the Minerals Management Service since the 19th of January, when it was established. Also with me is Alex Good, who is the Associate Solicitor for Energy and Minerals and is today the Acting Solicitor for the Department of the Interior.

I have a prepared statement, Mr. Chairman, which I would like to submit for the record.

The **Chairman**. It will be placed in the record at this point.

[The prepared statement of Under Secretary Hodel follows:]

Statement By
Honorable Donald P. Hodel
Under Secretary of the Interior
Committee on Energy and Natural Resources
United States Congress
May 17, 1982

S. 2305, the proposed "Federal Energy and Mineral Resources Act of 1982".

Mr. Chairman, it is a pleasure to appear before you this morning to discuss S. 2305, the proposed "Federal Energy and Mineral Resources Act of 1982." As you know S. 2305, as introduced, is identical to the Administration's proposal. We believe that enactment of this legislation is crucial if we are to improve the Federal royalty collection system.

Secretary Watt quickly became aware of the questions raised about royalty management when he assumed office last year and he was frankly surprised at the size of the problem and its complexity. One could almost say that America had no effective royalty management system at all. The system wasn't good enough even to tell us whether or not it was working. We found that total Federal and Indian oil and gas royalties had risen from less than $500 million in 1971 to an estimated $4 billion in 1981...and that these royalties were projected to exceed $14 billion per annum by the end of this decade. We found that the USGS had only 47 field inspectors to police 45,000 onshore wells on almost 18,000 onshore leases. In comparison, there were 75 people performing inspections on only 1240 leases offshore. We found that we did not have a reliable means of determining the magnitude of the problem and no practicable way of imposing penalties on those who failed to observe the very few rules and standards extant under that system.

It was because we did not know the dimensions of the problem that we could not accurately focus on overall solutions. We needed to begin improvements immediately and we initiated those improvements even while establishing a commission to give us the sort of fresh, unbiased perspective that only an outside study could provide. It was out of this realization that we asked David Linowes to chair the Commission that now bears his name.

At the same time, but on a separate track, we took a series of actions that appeared from the outset to promise the kinds of reforms that we needed. For example:

--We met with Governors of appropriate States to solicit their ideas and help.

--We invited the Interstate Oil Compact Commission, a multi-state body, to join us in identifying cooperative solutions.

--We more than doubled the authorized strength of the inspection force and began hiring and training additional inspectors.

--We initiated a lease-by-lease cooperative audit with the State of Wyoming and recovered more than $1.5 million.

--We are undertaking "look-back" audits to insure full payment of past due royalties.

S. 2305 was drafted by the Department in response to the Linowes Commission's recommendation that legislation be enacted to give the Department the legal teeth we need to conduct a better royalty management program. We believe this bill does that by providing a much-needed system of strong civil and criminal penalties for violations of the Act.

We have been fortunate to work closely with the staff of this Committee on this legislation. We have also met with staff people from the Select Committee on Indian Affairs. They all have put much time and effort into this proposal and we are very appreciative.

We believe that through these meetings we have reached agreement with the joint staff on a number of modifications to the bill. We have worked out a slightly amended penalty structure that we all believe addresses the concerns that were previously expressed about the penalty provisions in the bill.

We understand that the joint staff will be recommending that the scope of the bill be limited to oil and gas resources. We do want to point out that part of the problem with royalty management to date has been the lack of uniform statutory requirements with respect to mineral royalty collection. The only way we can achieve a truly successful and cohesive royalty management system is to conduct the entire program based on one set of standards and requirements. We ask the Committee to consider carefully the impact of this limitation and we strongly urge the Committee not to accept this recommendation.

We also understand that there has been some consideration given to including a state option proposal in the bill. Of most concern to us, is Title II of H.R. 5121 that would provide for the State collection of Federal royalties. We have no objection to the concept of a State program provision. The one contained in H.R. 5121, however, is highly objectionable. It requires the Secretary to turn his auditing and collection responsibilities over to any State that requests those responsibilities in writing regardless of its ability to administer those responsibilities. The Secretary would then have to continue to oversee the State's conducting of the collection program and would have to be prepared to resume his responsibilities, after a time-consuming and potentially controversial funding process, in the event that the State is not exercising due diligence in carrying out those responsibilities. The State would keep 50% of all royalties collected, then deduct up to 5% from the remaining 50% for the State's expense of administering the program. The Federal Government would then be left with the remaining 45% and would be responsible for paying the windfall profit tax due on the entire amount from that 45%.

The Federal royalty collection program currently costs less than 1% of the royalties collected. Thus the Federal Government's share of royalty revenue would be significantly reduced by enactment of this provision. We request that no such proposal be adopted by the Committee.

I would now be happy to answer any questions you might have.

Mr. Hodel. Much of the material in that statement has previously been testified to before this committee by Mr. Pendley and others representing the Department. It outlines the seriousness of the problem. It outlines the administrative steps which we have taken to begin to alleviate the problem and it points to the fact that the reason we have proposed this legislation, which is Senate bill 2305, is that it is a part of our effort to implement the recommendations of the Linowes Commission. Those recommendations included a recommendation that we have a system for enforcing the requirements that are needed—in accordance with the direct recommendations of that commission—in order to accomplish the things that have been talked about by so many people, not only members of this committee over time, but also members of the House committee, General Accounting Office and so on.

I have a number of comments with regard to the legislation. I suspect that we will have a chance to discuss those as the questions evolve. That is all I have at this time.

The **Chairman.** Thank you very much, Mr. Secretary. I said at the earlier hearing and I will repeat now the Secretary is being commended for having moved as promptly as he did, first, recognizing the problem, and, second, appointing the Linowes Commission and, third, implementing the recommendations of the Linowes Commission.

Far too often we have seen around here the commission appointed and coming in with very good recommendations and then they gather dust on the shelf. There is no dust gathering on this one and I appreciate that.

Senator Melcher, I wonder if you would like to question Secretary Hodel.

Senator **Melcher.** First of all, Mr. Secretary, I would like to know what is the effect of the action taken last week regarding Amoco and Sohio leases on Wind River Reservation.

Mr. Hodel. Senator Melcher, I am sorry to report that I am not personally acquainted with that action. I will check to see whether any of the people who have accompanied me here are.

The **Chairman.** I would ask Mr. Pendley to comment further.

Mr. Pendley. Senator, as a result of some issuances of noncompliance on the Wind River Reservation, the Minerals Management Service was requested to do an assessment of the various things that were issued in that case and to make a determination and a recommendation to the Assistant Secretary for Indian Affairs regarding the possibility of cancellation of the Amoco lease as a result of violation of the terms of the lease.

Senator **Melcher.** Do you have Mr. Smith's letter of last week? Do you have it available?

Mr. Pendley. I do not have that letter.

Senator **Melcher.** What did it say?

Mr. Pendley. I do not have that letter.

Senator **Melcher.** What did the letter say? It was cleared through the Department, was it not?

Mr. Pendley. Not in the position in which I operate, Senator. We had a recommendation to the Assistant Secretary for Indian Affairs regarding the steps that he should or could take with regard to that lease. That is a matter now within the office of the Assistant Secretary for Indian Affairs. I have no further knowledge of what action he took.

Mr. HODEL. Perhaps it would be useful, Senator, if we had somebody dispatched to obtain a copy of the letter and also anybody who could assist us.

Senator MELCHER. I wonder if we could do that. Because it is my understanding that the letter said to vacate the leases.

Mr. HODEL. Mr. Chairman, if I may comment further on that, I think that while I am not personally familiar with that specific act, it is precisely the kind of thing that we have recommended be done by the Minerals Management Service or, in the case of an Indian lease, by the Assistant Secretary for Indian Affairs. We have recommended that, where actions are required in order to enforce the lease terms or the lease provisions, they should be taken, and that we not find ourselves continuously in the position where we have not acted after a considerable number of provocations.

So I am assuming that that is what has taken place here, but I am also assuming that before much longer in this hearing that we will have both a copy of this letter and perhaps somebody who can assist us with the specifics regarding that.

Senator MELCHER. I do have some specific questions and I will start with S. 2305. Does that contain a provision for the cost of the royalty accounting system, including collection, to be borne by the Indian tribes and the States for their share of the royalty on the Federal leases?

Mr. HODEL. Yes, Senator. This would provide that we would collect the cost of collection before disbursing the royalties.

Senator MELCHER. It would come out of the Indian tribes' royalty?

Mr. HODEL. In the case of Indians it would have that effect, because 100 percent of the royalties collected go to the tribe. This would mean that an amount less than 1 percent would be deducted first and then the balance would be distributed to the tribes.

Senator MELCHER. And in the case of the States, the costs would come out of the States' share of the royalty.

Mr. HODEL. They would participate in it in a proportionate share or in relation to the amount that they received, because it would be deducted on the basis of the total royalty collected. So they would, in effect, pay, if they received half of the royalty, half the cost.

Senator MELCHER. Who would pay the other half?

Mr. HODEL. It would be nominally the Federal Government would pay it, but the receipt would be the same. It is a wash item.

Senator MELCHER. You would have to wait on the appropriations for this service.

Mr. HODEL. Ideally, if it worked that way. I would have to qualify my answer because the question is whether the 1 percent would completely cover the cost of collection. That is a relatively low percentage of expenditure for the kind of complexity that we find in this area and so I say yes, qualifiedly.

Senator MELCHER. S. 2305 is quite a lengthy bill, but is not much of the authority discussed in S. 2305 already present law?

Mr. HODEL. Senator, I believe that a portion of the authority exists in existing law and we have attempted to exercise some of those authorities. What we have here is a bill which responds, and is lengthy because it attempts to respond, to the proposals of the Linowes Commission.

S. 2305 provides a systematic approach to royalty collection which would be unique and certainly long overdue. We feel that a bill that has taken the care to define at length the terms that are utilized, which spells out in detail the duties of lease holders and operators on those leases, which spells out some of the responsibilities we have and then identifies the penalties which can be imposed for civil and criminal violations, is precisely the kind of bill that needs to be adopted here in order to regularize this process.

While some of these authorities may exist and we have attempted, I think, by administrative order to implement many of them, it is my understanding that it is not at all clear that we will necessarily prevail if we are challenged on some of those actions that we have attempted to take, which are viewed widely as necessary steps, if we are to have a responsible and effective royalty management collection process.

Senator **Melcher**. On page 31, the bill says to "apply to any existing leases, permits or applications for leases or permits issued under the mineral leasing laws such rules and regulations as may be promulgated under the authorities granted by this Act;". That is retroactive.

Mr. **Hodel**. Senator?

Senator **Melcher**. Page 31, at the top. It is apparently retroactive and is against the Constitution.

Mr. **Pendley**. Mr. Chairman and Senator, the reason for this——

Senator **Melcher**. Excuse me. I am looking at this after it has been——

Mr. **Pendley**. We now have a copy, sir.

The **Chairman**. Might I ask a question and maybe you can focus on that. As I understand a good many of the existing leases that are in effect now say that they are subject to whatever rules and regulations that are now or hereafter may be promulgated. That may not be the exact language, but that is the effect of the leases.

I would assume that the question might be addressed to whether or not there are other leases that do not have that provision in them.

Mr. **Pendley**. Mr. Chairman, I think that all of the leases do have that language in them. I think that past court actions, as I understand it, have upheld the Secretary's authority to revise regulations as they apply to a lease. But one of the particular concerns of ours with regard to this first-day notification was with the recommendation of the Linowes Commission for such notification on the first day of production.

We are able to require, and we have amended all of our APD's subsequent to the order that we issued on the 1st of February to require, that an operator notify us on the first day of new production. That applies to all new APD's. We have about 2,300 leases which have been issued and APD's that have been issued that are outstanding, that do not have that new requirement in them. We are concerned about that first-day notification and this particular section specifying such notification.

Senator **Melcher**. Well, let's clarify this point. Any lease that has that phrase in it, and I assume all of them do, are subject to additional regulations that the Secretary may promulgate, whether based on exising law or based on something that is prospective. The point of this question is just how do you apply this rather broad authority—I don't blame the Secretary for asking for broad authority—but I would like to know what rules and regulations do you envision may be promulgated under this act.

I think that is the point. This is a new act. It is pretty lengthy. It has a lot of discretionary sections in it. What new requirements do you contemplate that you are going to impose on existing leases?

Mr. **Hodel**. Senator, we want it clear that this statute and that the rules and regulations that we prescribe pursuant to this statute, in order to effectively collect those royalties that we are entitled to apply to existing leases, I know that you have been very concerned about this as has the chairman and other members of this committee. We want no doubt and no argument about whether the rules and regulations apply to those leases, those permits, and those applications for leases at whatever stage in the process they may be.

Particularly, it is important to us that when the rules and regulations are applied that especially the civil penalties portion of the act be applicable. I think that would be the primary thrust, the primary concern. As more than a few people have commented and noted, the present penalty provisions, and I am sure we will talk more about penalties, are not even a slap on the wrist, in view of the dollar volumes that we are concerned about.

The Linowes Commission talked about and the General Accounting Office has talked about as much as $1 million or $2 million a day is being lost. We can't casually respond to that and it seems to us that a $5 or $50—excuse me, a $10 or a $50 penalty is simply not effective. It is not even high enough to be called a license to evade the regulations.

So I think this is clearly intended and would be applied for the purpose of seeing to it that the rules being made pursuant to this statute are broadly applicable to the whole system.

Senator **Melcher**. As to the $1 million a day syndrome—I will call it syndrome now, because that figure has been tossed out so often—is it your feeling, Mr. Secretary, that that is $1 million a day in actual loss of oil and gas that is not reported? Or is it $1 million a day that is not accounted for because it is lost somehow in the paperwork that is generated on the reporting of the production? Or is it $1 million a day because the payments are so late that the interest adds up to $1 million a day?

We have had this figure floating around now for a little over 2 years. The first time I heard it I think it was from Secretary Watt himself and it was based on what he had been told by U.S. Geological Survey people.

I would like to know what you personally feel could account for $1 million a day.

Mr. **Hodel**. My understanding is that the number first surfaced in testimony before a Senate or House committee and, frankly I don't recall, by a Geological Survey spokesman. It was very much viewed at that time as the high side of the risk of loss and my understanding of the loss that was involved was that it was the lost royalties of the Federal Government.

These were lost collections of royalties to the Federal Government, so that it represented one-eighth or one-sixth of the moneys that should have been paid to the owners and other holders of rights in these leases. Subsequently in the Linowes Commission and hearings of that Commission, Dr. Linowes and the balance of his Commission concluded that the $1 million a day figure could be very conservative.

Our own Inspector General has concluded that that number could be conservative and in establishing that number it is not just thefts which are exceedingly difficult to estimate, but it is a combination of thefts, underaccounting, miscalculations, the composite of activities.

I don't know whether lost interest on late payments would be included, but that would be such a relatively small part of the overall, relative to $1 million a day or $2 million a day loss, that it would be relatively speaking insignificant, though not absolutely speaking insignificant.

Those numbers, as I understand it from both the Linowes Commission and our Inspector General, were provided by virtue of a percentage estimate of the loss. Their conclusion was on the work that has been done to date. As a result of the auditing that has been done to date, they find something in the neighborhood of *x* percent, in this case 3 or 4 percent or so, that was inadequately reported. It does not take into account theft.

And they extrapolate from that that, if we are receiving $5 billion a year in royalties and there is a 5 percent shortfall, that is $250 million. It does not include theft. If there is any theft at all, it rapidly reaches the $360 million level, which would be $1 million a day.

The Linowes Commission report had some estimates that ranged as high as 10 percent. If you get into that range you are now talking about the $2 million a day level. What it points out, Senator, again, and I know this is something which I think is agreed to by all the parties, this is a condition which has gone on according to a recent GAO report for 20 years.

Administration after administration, without regard to partisanship, has not been able to deal with this issue. We have moved as aggressively as we can and we have tried vigorously to improve this collection process. We have a considerable way to go and we feel that enactment of this legislation would be most useful and helpful in effectuating these collections.

Senator **Melcher**. I will use your figure of $250 million a year lost due to improper accounting. If I interpreted your answer correctly, that is a fair assessment of loss due to improper accounting. Is that correct?

Mr. **Hodel**. That is according to one estimate, yes.

Senator **Melcher**. Since the accounting is in the hands of the Department of Interior, what specifically does this bill do to improve the accounting? I think we are getting right to the basics.

Mr. **Hodel**. Right. I think two very significant things are done by this bill. First of all, it prescribes the responsibility of the lease holders and operators to report and to keep certain kinds of records. And, second, it provides a meaningful civil penalty provision in the event, among other things, they fail to keep those records.

Senator **Melcher**. Now what are the records and the reports?

Mr. **Hodel**. We are looking at section 5(c) 1, 2, and 3, page 32 of the committee print. Actually step 1 is the requirement that the secretary be notified on the first business day after any new well begins production.

Senator **Melcher**. We might as well start right there.

The **Chairman**. Before going into that, may I ask a couple of questions? Because I know one of the recommendations, you covered this in your prepared statement, is that we have been applying the application of the bill just to oil and gas. I think the Linowes Commission applied a percentage estimate and simply that they did not say it was more than that.

They applied it to all minerals and as I recall the $5 billion estimate was the receipts of all minerals and not just oil and gas. That ties back to my memory to something that was mentioned 3 or 4 years ago about the trespass cases or loss of royalties or at least loss of coal in the Eastern coal fields. Does not BLM have an authority and a responsibility and a problem with respect to the protection of minerals other than oil and gas?

Mr. **Hodel**. Thank you, Mr. Chairman. We do. I think the reason the Linowes Commission recommended as it did that it be applied to all minerals and the reason we would support that and would continue to support that is that this is a generic problem. It is not just an oil and gas problem. The focus has been on oil and gas because it is, by far, the largest portion of the dollar pie at the moment, but we have the same problems with a $10, $50 penalty provision with other mineral resources.

The **Chairman**. The reason I ask the question is I don't remember for sure whether that eastern coal question was a royalty question or a trespass question. I think it may have been a trespass and not a royalty question. But is that a separate problem to be treated separately or is it part of the same problem?

Mr. **Pendley**. Mr. Chairman, one of the responsibilities of the new Minerals Management Service, as it was the responsibility of the Conservation Division of the U.S. Geological Survey, is to perform those inspections. In the cases you bring up of the trespass situation in Alabama, that was a joint exercise in which BLM and MMS engage in an attempt to uncover that trespass situation and the amount of coal that may have been misappropriated.

The **Chairman**. Even though that may be true, the Linowes Commission looked only at oil and gas problems.

Mr. **Pendley**. That was their responsibility. They did, as you know, Mr. Chairman, indicate that while they had only focused upon that, some attention should be paid to the other.

We are looking at a situation where we collect $100 million annually from nonoil and gas production—from coal and others. We expect that, in 1986, the royalties on these coal lands will jump from an average 3 percent to an average 10 percent. We will have a 7-percent jump in the amount of royalties that we collect.

With the increase in coal production that we expect, we are concerned that royalty collection on coal production will be a problem in the future and that we need to have that same strong, tough reporting requirement—that we now want to impose on the private sector as far as oil and gas—applied to the coal and other minerals as well, sir.

The **Chairman**. Again, not to belabor the subject, but if you look at the Linowes Commission report at page 181, in their recommendation No. 9, which is pages 180 and 181, there is a note on solid energy minerals, on the second page. In particular they mention that they briefly reviewed some of the problems of the royalty management for solid energy minerals and they characterized it as a preliminary review and they say it appears that it has general problems of verifying production, et cetera, which may be the same or at least similar and they say that the Commission believes many of the recommendations of this report, which would formulate primarily oil and gas royalties in the mine, may be applicable as well to managing royalties from solid energy minerals.

And then they suggest that managers of the Federal royalty program carefully study the solid-mineral royalty area and make sure the changes in the mineral royalty management system are compatible with solid energy minerals.

They concluded by saying that it should be done before the final system design was completed and I suspect before we have completed this part of the hearing, before we have made a decision, we need to be assured that we have made that indepth study of the solid minerals question and determined that the bill is applicable to the solid minerals as well as to the oil and gas.

Mr. **Pendley**. Mr. Chairman, we have taken the step and you bring the point here in your reading of the recommendation. We have taken precautions to insure that the new system, the royalty accounting system will be applicable to all minerals including oil and gas, coal, and the others.

That is all part of the new system that we are devising. We can be responsive to your request in regard to the ways in which that is being done and perhaps that will be somewhat responsive to your concerns. But we believe that the whole package should be together. We don't want to find ourselves in another 5 years coming again to the Congress and saying we have discovered a brand new problem here with regard to nonoil and gas resources.

Senator **Melcher**. I would like to note that the Linowes Commission met several times over the course of about 5 or 6 months. The Commission had a limited amount of not only testimony, but a limited amount of staff to look into all of these things. The 62 various recommendations are sort of a glossary of where to look to find out what to do to correct the situation.

They were not in a position to be definitive and they were not in a position to work all those recommendations in a statute. I don't think that they purport to have been the experts on the existing statute.

And so now what this committee and the Indian Affairs Committee and the Senate and the House are confronted with are those parts of the existing statute that need to be changed and that is the point of my question. I would like to mention, Mr. Secretary, before we get back to the first-day notice requirement, that sections 5, (1) and (2) are, I believe, patently required now. I don't think there is any doubt on that. But there may be some reason why you may want to restate it in this proposed bill.

Mr. HODEL. Failure to include this in the bill would mean, of course, that we would have to look outside this bill to identify the authority or the source of the authority, not that that should be a serious problem.

Senator MELCHER. My point is that it is required. Is it not required, Mr. Good?

Mr. GOOD. It is indeed required.

Senator MELCHER. Now, perhaps you can tell me exactly why you want to restate it here.

Mr. GOOD. I think there are a couple of reasons. The first of which is that this is a comprehensive bill intended to deal with the totality of the problem. I think it clarifies the existing authority to put all of the Secretary's authorities and all of the duties of the interest holders, operators, and lessees in one bill.

But beyond that, I think we also want to make it absolutely clear what civil penalties will apply and to insure that section 5 will be included within the civil penalties. Now, we probably could do that outside the bill, but we thought that this vehicle was the most appropriate way to solve the problem of letting the interest holders and lessees and operators know about their obligation and what the penalties will be if they violate them or the potential penalties will be if they violate their obligations.

Senator MELCHER. I think that is well stated. While I am not sure myself whether the penalty is tight enough or loose enough, I think you have stated it well and I have to agree with you. It should be restated and it should be made clear that violators are subject to civil penalty. Are there any criminal penalties involved in either one or two?

Mr. GOOD. To be quite honest, Senator, I am not up to speed on the most recent iterations in the changes in the criminal penalties, but it is my understanding that a violation of section 5 was potentially subject to criminal violations as long as there could be proof that it was committed knowingly and willfully, there was known and willful violation. In other words, if there was a negligent omission or failure to pay a royalty by a certain date, that would not be subject to a criminal penalty. But a knowing violation could potentially be subject to a criminal violation.

Senator MELCHER. Mr. Secretary, returning to the first-day report which requires notification to the Secretary on the first business day after any new well begins production anywhere on the lease site by such means as the Secretary may prescribe.

There are two things here. To begin with, I am sure that present regulations require that the Secretary be notified when production starts. Now, tell me what this language is expected to do that is not done now.

Mr. HODEL. Apparently now, Senator, the reporting of the first day of production may take place somewhat haphazardly, sometime between the first day of production and the first day that somebody decides to notify us that production has occurred and I am informed further——

Senator MELCHER. How long could that be?

Mr. HODEL. I have recently been apprised that can, in some cases, be as much as several months.

Senator **Melcher**. And that is in violation of the regulations. Is it not?

Mr. **Hodel**. I believe it would be in violation of the regulations now. A $10 fine or a $50 fine or penalty, it really is not a penalty or a fine under the present rule, but anyway an assessment is hardly anything significant for that kind of departure from the reporting requirement.

Senator **Melcher**. Does that not also constitute fraud?

Mr. **Hodel**. Arguably, it does, but I assume that there are technical arguments to be made. For instance, I am informed that in some cases that it is not until after a certain piping has gone in and tankage and the meters installed that we are finally informed that the well is in operation.

It does not mean that oil has not been removed from the premises in another fashion.

The **Chairman**. Let me ask the acting solicitor, before fraud is involved, you have to prove an intent and the failure to report on the first day of production would have to be tied to some intent to deceive or defraud. So you would have to prove the fact and then you would have to prove the intent.

Mr. **Good**. Indeed fraud is very difficult to prove, as we all know.

Mr. **Hodel**. In this particular case, as I understand it, there is the very, at least superficially, reasonable argument that, well, I was not in a position to transport oil from the premises until I had all of this equipment in and the metering and so I did not know that somebody was out there taking it.

Senator **Melcher**. I want to get into production later.

Mr. **Hodel**. In any event, what that does is it explains why we think it is important to have first day notification of oil production from the well.

Senator **Melcher**. I want to return to the point where production occurs. I think we looked at six gas wells, did we not? We looked at six gas wells, because it is not very easy to understand what goes wrong unless you look at specific cases. We had these wells monitored by a rather competent ex-employee of the Bureau of Indian Affairs who was knowledgeable on procedures of auditing.

Now, we found that for one or two of those wells the gas production was not reported for a matter of 6 months. Whether or not that is fraud, we get back to the point that even if the royalties are eventually paid, the 6-month lag from the begining of production to first date of payment certainly constitutes a loss of money in terms of interest. And these wells began producing during the period when interest was 18, 19, or 20 percent. I guess interest rates are still about the same.

Mr. **Hodel**. I think it is a little lower, Senator.

Senator **Melcher**. I don't know if for that particular Indian tribe, rates were any lower. I think the regulations were clear enough. They were violated, first of all, and unless the interest was paid, the tribe evidently lost some money,

Mr. **Hodel**. Under the present situation, as I understand it, if I misstate this, I trust that one of my companions here or others I brought with me will straighten me out and the record as well, but my understanding is, under the present situation, we have very limited and questionably effective tools available to us for that precise situation.

We have the alternative of a $10 or $50 a day penalty, which is nothing for the kind of activity you are discussing. We have the alternative of shutting in the well, which means that the Indian tribe at that point will receive no royalties at all, because we cut off production and, if it has an adverse effect upon the well, it may be really a matter of cutting off our nose to spite our face or the alternative of terminating the lease.

Here again, unless there is some clear opportunity to place another operator in possession promptly and continue the production, it is questionable how effective that would be.

Senator **Melcher**. Here is how the operator and the company responsible for paying the royalty stated it. First of all, the company was a Canadian company who had somebody else operating the well. The Canadian company said that they tried to figure out how to start making the payment and in what amount but had difficulty in finding out.

The area office in Billings at GS could not tell them, because they were not involved in collecting royalties. It was not clear to me when they got around to talking to the Casper office, which was in charge of collecting the royalties.

Who is going to establish for Minerals Management the duties that GS formerly had? Who is going to establish on the ground when the production starts? And I think that is the basic point—how do you do that? Are you going to have a company report, which is the system that is in practice right now?

Mr. **Pendley**. Mr. Chairman, under this legislation we would draft regulations which would be applicable to the operator and would impose that duty to notify the Minerals Management Service and the regional manager when that production came on line.

Senator **Melcher**. Who is going to verify that? Are you going to have an inspector there when production starts? I think we are getting now down to how this works not just a bunch of words and a bunch of proposed regulations that might be thrown out later on. Are you going to have an inspector there to say this well is now in production?

Mr. **Pendley**. Mr. Chairman, that it is not our intention at this time and, of course, we are looking far into the future past this legislation and past the regulations being promulgated and implemented. But it is not our intention, at this time, to insure that an inspector would be onsite that first day of production.

As you know, from your experience in the industry, these things change. Certain days you think they might come into production for the purpose of a sale but production might not take place for a variety of reasons. What we do have as a result of this first day notification is the date when they actually began production and finally pay royalty. If we find that they have not notified us this legislation gives us the teeth we need to issue fines and to insure future compliance.

Mr. **Hodel**. And elsewhere in the bill, Senator, we are provided the authority to inquire of them their necessary records. They are required to keep certain records and we are permitted, under this legislation, to have access to those records in order to establish that first day of production.

Senator **Melcher**. I think that is already in the regulations on oil. You already have a first day production. I think you do on gas also. I am not sure what this first day means. What does production mean? That if you test these wells and it is oil, you find out how much water is there, et cetera, et cetera?

Mr. **Pendley**. First day production, Senator, means the date on which that well is ready to be dedicated to sales. The testing procedure is completed and they are ready for dedication for production for sales.

Senator **Melcher**. Now, to get to that point, when is the first time you have an inspection? The present law requires, does it not, that you have an inspection before they spud in the well, to see what they are going to do to protect the soil and the surface of the land?

Mr. **Pendley**. You are correct, Senator. With regard to the issuance of the APD, we do have coordination responsibility with the surface management agency, whether it is Forest Service or BLM to insure proper protection and that the location site or proposed location, is suitable for a well site and that mitigation measures are taking place. That inspection, you are correct, does take place.

Senator **Melcher**. When is the next inspection?

Mr. **Pendley**. Mr. Chairman, that has been a matter of some controversy as a result of the Linowes Commission recommendation. It was their conclusion that we lacked, the Department of the Interior in the past has lacked, an effective inspection/enforcement strategy. As a result of the recommendations of the commission and a report issued to us by our quality assurance team, made up of some of our key staff people throughout the country who have experience out in the oil patch, we are now devising an inspection/enforcement strategy to increase our presence.

In addition, we are working with States and with the Indian tribes to increase our presence on the oil patch through cooperative arrangements. We are working, as well, with the royalty management accounting office to insure that any exceptions that might pop up or any problems that they detect would be reported to our inspection team, to get them out in the field where problems exist.

Senator **Melcher**. Does that not mean anytime the first day that something is presented for sale or stored for sale? Is that not correct?

Mr. **Pendley**. That is correct, Mr. Chairman.

Senator **Melcher**. Now, I would like to ask Mr. Campbell, of the quality assessment team, what is new about this? What does the current regulation call for on production?

Mr. **Campbell**. Right at the present time?

Senator **Melcher**. Right at the present time.

Mr. **Campbell**. Right at the present time we receive a first production memo in the district office, which is word that the well is on production. There is a first production report that is written for the files and sent into the inner office.

However, this first production report might be, like Secretary Hodel said, 30 days, or 3, 4, 5, or 6 months after production begins. It is my understanding this first report of production would either be by telegram or telephone to the district office that would be in charge. This would then permit us to go verify that this well was on production.

Now, we verify, on drilling rigs we are notified of, the time the rig is spud. We are notified at the time the surface pipe is set, so we can check the OP's. So there would be no problem in that company notifying us on the first day of production. This would give us the ability to go in and see and verify the first day of production.

The CHAIRMAN. Does not the current law require a monthly production report?

Mr. PENDLEY. Yes, sir.

The CHAIRMAN. If they are 5 or 6 months from the first day of production to notification of the first day of production, they are in violation of current law and regulation for at least 5 of those 6 months. Is that correct?

Mr. PENDLEY. Yes, Mr. Chairman. The problem is they may well have been underpaying their royalties as a result of their report of production. But the problem that the Linowes Commission perceived and the problem of our royalty accounting office in Denver is that we do not know when that royalty accounting is coming in. We don't know that there is someone in the oil patch and that there may have been a discovery, that it is ready to go into production, or has already gone into production and the royalties are in the owing.

And what the royalty accounting office needs to know is when they are to expect a payment, and from whom to expect this payment. So we need to have that information, so when they are late we are ready to go after them.

The CHAIRMAN. Under current law they cannot be in violation of the law or regulation but not to exceed 30 days, if they go from production without filing a production report within 30 days they are in violation of current law.

Mr. HODEL. That, I believe, is correct. Then we are back to the question of what options do we have in the way of enforcement and those options have not been effective. If there is anything that comes through from the record, Mr. Chairman, it is that enforcement has not been done effectively, for whatever reason, and I think at least a significant part has to be attributed to the penalties. There was a time not too long ago, it was last summer in fact, when we began imposing interest charges on late payments and, until that time, we were providing the cheapest borrowing available to the market. They did not have to pay and when they did they paid no interest.

The CHAIRMAN. Again, perhaps we are in danger of forgetting we are talking about not just oil and gas. How many drilling rigs are there active onshore in particular the 48 States?

Mr. PENDLEY. We figure that, Mr. Chairman, we have about 44,000 wells on 17,000 leases in about 23 or 27 different States.

The CHAIRMAN. And how many active drilling rigs?

Mr. PENDLEY. I don't have that number.

Mr. HODEL. We are being advised, Mr. Chairman, that the last count that our staff has seen would be that there are 4,000 active rigs, not all of which are on Federal lands.

The CHAIRMAN. Does that include offshore?

Mr. **Wyatt**. Yes, sir.

The **Chairman**. So that is all the drilling activity onshore, offshore on Federal lands, on private lands?

Mr. **Hodel**. And on State lands as well.

The **Chairman**. Could you give me a figure on how many of those may be on Federal lands at any one time or lands in which the Federal Govennment has an interest?

Mr. **Wyatt**. We would have to supply that number, sir.

The **Chairman**. If you would do that please. You have, I think, how many inspectors, 80 and 75 and 20, if I recall correctly in three different groups.

Mr. **Pendley**. We have onshore, at the current time, an authorization for 50 inspectors originally and we have taken that number up by some reprograming to approximately 100. We now have onshore 83 inspectors and we are working toward our 100 number.

The **Chairman**. According to the information that I have here it is 75 OCS, 80 onshore and 20 on other mineral producing leases. That is moving upward as you seek the increase. Is that correct?

Mr. **Pendley**. That is correct, Mr. Chairman.

The **Chairman**. We are not talking about OCS and then you have got 83 inspectors to inspect all of the numbers that you have given.

Mr. **Pendley**. That is correct, Mr. Chairman.

The **Chairman**. Whatever that may be on Federal lands, you have got, again, a number of leases to inspect. You have to continue to inspect those that are in active production. You have got 20 but look at all of the nonoil and nongas minerals on all of the public lands. That includes the State of Alaska and, as I said earlier, the 48 contiguous States. We don't know of any oil and gas leases in Hawaii, but there are some in Alaska.

So you have 49 in 50 States that may be involved and the inspectors just have not the new production to inspect. They also must supervise the production or at least inspect the production on all of the existing wells and there are some 47,000. Is that correct? That is existing producing wells.

Mr. **Pendley**. Yes, sir.

The **Chairman**. On Federal lands.

Mr. **Pendley**. Federal lands and Indian lands.

Mr. **Hodel**. Mr. Chairman, that highlights again the significance of a number of aspects of this bill. Like the Internal Revenue Service, we do not have enough people to have somebody located at every well all of the time to pursue this, even on a monthly or 2-month basis.

We have got to have a self-reporting system, but to be effective it has got to have teeth in it and that is why I think we are so much in need of this kind of legislation.

The **Chairman**. Mr. Secretary, I think that points to a fundamental choice that has to be made in enforcement of any Federal statute. That is whether you have enough inspectors there to look at every activity by every operator or whether you have spot checks to determine violations with sufficient penalties assessed to make certain that people are not tempted to violate.

That is similar to the IRS. We think the IRS is far too omnipresent. But as a practical matter, we are the only Nation in the world that depends on a voluntary system of compliance. We sometimes do not think it is very voluntary, but we do, we do sit down, provide all of the information, send the report in, send our taxes in and not all of those returns are audited. They are spot audited.

And the thing that makes the system work is a sense of responsibility on the part of those that are motivated by a sense of responsibility and a sense of fear by those who are not. And that fear is induced by severe penalties. What we have lacked in the minerals enforcement in the past in the royalties collected is the sense of fear and apparently not a sufficent sense of honesty.

We have to make up our minds to either introduce enough inspectors to inspect all of the activities or introduce a penalty system that is severe enough to induce other people who otherwise would be tempted to disregard the law to respect the law, at least not in terms of the intangible rewards that come from virtue, but the more tangible rewards that come from failing to get caught.

Mr. HODEL. Thank you, Mr. Chairman.

Senator MELCHER. If there are any new wells that begin production, the production means actually putting oil in storage to sell or gas going on line for sale. Is that correct?

Mr. PENDLEY. Yes, sir.

Senator MELCHER. Now, you are going to have a company notify MMS and this which is already covered by existing statute. As George Campbell said, it is his understanding there would be a telegram or a telephone call to the district office. Since you know that this is a good step, is that being done now as of today?

Mr. PENDLEY. Yes, sir, it is. We have already done that with regard to the issuance of our APD's. All prospective APD's will have attached to them a requirement, that they notify our regional managers on the first day of production.

Senator MELCHER. Regional manager. That is not the district office.

Mr. PENDLEY. I think it is the regional managers. I sent the instruction memo out to the regional managers. Maybe that is correct.

Senator MELCHER. How many regional managers are there?

Mr. PENDLEY. I think we have five onshore.

Senator MELCHER. It is not as George stated it, that it will not go to the district.

Mr. PENDLEY. No, it goes to the district, Senator.

Senator MELCHER. It does go to the district.

Mr. PENDLEY. Yes, it does. I misspoke.

Senator MELCHER. You have got that in place now?

Mr. PENDLEY. That is correct with regard to all new APD's.

Senator MELCHER. All new ones.

Mr. PENDLEY. All new ones.

Senator MELCHER. For the record would you identify what APD means.

Mr. PENDLEY. An application for a permit to drill.

Senator MELCHER. So that requirement will mean that the producer will notify the district office.

Mr. PENDLEY. That is correct.

Senator MELCHER. The first day.

Mr. PENDLEY. First day.

Senator **Melcher**. And that will be production as identified by having a product ready for sale. Let us take Billings as an example. How many inspectors are there there?

Mr. **Pendley**. Senator, I don't have the figures on how many inspectors we have located in Billings. I can provide that for the record.

Mr. **Wyatt**. We can provide that for the record.

Senator **Melcher**. You don't have how many are there now.

Mr. **Pendley**. No, sir.

Senator **Melcher**. This is a change, is it not, to avoid the problem that I mentioned with the gas well?

Mr. **Pendley**. Senator, it is a response to the recommendation of the Linowes Commission. They apparently discovered much of the same information and problems that you alluded to and it was their recommendation that we make this a requirement and the Secretary has adopted all of the Linowes Commission recommendations and we moved forward on that recommendation at a very early date.

Senator **Melcher**. George, can you tell us when this information was given to the district office.

Mr. **Campbell**. I believe it was about 2 weeks ago we received our memo.

Senator **Melcher**. Prior to that time how many years ago was this information provided to the district office as routinely as possible and as promptly as possible?

Mr. **Campbell**. We are suppose to receive the well completion report and, first time notification on the 9-329 monthly report.

Senator **Melcher**. Which is the monthly report.

Mr. **Campbell**. Yes, sir.

Senator **Melcher**. Looking backward now, was that not changed? The 9-329 monthly report was not provided to the district office in the past.

Mr. **Campbell**. Yes, sir. Many of the operators did not report in the remarks column the date of new production. So consequently we received notice of first production when we received the completion report.

Senator **Melcher**. Now, you will have to state that again so I understand that. I don't follow you.

Mr. **Campbell**. I believe Mr. Wyatt could answer that. Is it not if it were on the 9-329 monthly report of operations that would not be due for approximately 60 days. It would be 30 days after the first month's production is to be reported.

Mr. **Wyatt**. Senator, we are talking about two reports here actually. The lessee operator who drills the well is held by the regulations within 30 days after the completion of that well to file with us a complete well production history and log that indicates a full summation of the drilling operation, and the initial potential of the well when that was tested.

It can be at that time that well is being actually placed on production, if the existing marketing facilities are there. Now, once you spud the well, that well is to be picked up on the 9-329 monthly report of operation and retained on there.

Senator **Melcher**. That is the monthly report.

Mr. **Wyatt**. Yes, sir. When its status changes, the drilling has been completed and there is a producing well that should be reflected on the 9-329.

Senator **Melcher**. What procedure do you have for notifying the district office? The 9-329 goes to the regional office, right?

Mr. **Wyatt**. In duplicate, one copy of which was to be sent to the district. That was the former notification process for wells being placed in production. Now, we have the first day notification. That requirement being attendant to all APD's that are now approved.

Senator **Melcher**. Then a blind spot has been covered, because I understand the district office was often unaware and I am glad to hear it is corrected now, that the well was under production until somebody from the regional office happened to notify them and I understand that did not happen for months. Is that correct?

Mr. Wyatte I think that is correct, sir, and also we are very hopeful it eliminates inadvertence on the part of operators reason of failure to include that information on the 9-329.

Senator **Melcher**. From the operator's standpoint, how does the telegram, I guess the mailogram nowadays, would be in effect of something like a letter going to the district office. Would it not?

Mr. **Wyatt**. The notification or the attachment that Mr. Pendley has was to be in some form of writing, either in a telegram or some written communication and was to provide certain specific information.

Senator **Melcher**. And that would go directly to the district office?

Mr. **Wyatt**. Yes, sir.

Senator **Melcher**. Does it trigger the accounting? The accounting will still be done in the regional office, isn't that correct?

Mr. **Wyatt**. Well, it is being partly done in Lakewood.

Senator **Melcher**. Let us use that monthly report, the 9-329. Where is that sent?

Mr. **Wyatt**. The 9-329's at the present time are still sent to the regional office in duplicate, a copy going to the district.

Senator **Melcher**. To the district. Is that one of the recommendations of the quality assessment team?

Mr. **Campbell**. Yes, sir.

Senator **Melcher**. If this is supposed to give the opportunity for Mineral Management Service to have an inspector actually go to the field and check what is going on in regard to one well or a number of wells, what is being done to assure a sufficient number of inspectors to be meaningful?

Mr. **Hodel**. We are continuing to seek additional inspectors. As we indicated we increased the number of inspectors authorized to over 100. Whether that is going to be sufficient remains to be seen and I think there are probably quite a few who doubt that. But we could set the number at any level we wanted right now, Senator, and it would not do any good if we cannot find people or cannot recruit them.

I think there has been a very active effort, but it is a slow effort, to acquire people who will serve effectively as inspectors and then, of course, we have engaged in an extensive training program for those that we have been bringing on.

The other thing this notice does is go to the accounting people and alerts them that they should be expecting a monthly report at the end of that month in which production begins and it will not suddenly be a surprise. If they don't get notice of production, they have no reason to expect such a report. Second, I understand that in the past, when they have received the report, they have wondered where it came from, not knowing that it was on the griddle.

So here it is now. This will be effective for the accounting as well.

Senator MELCHER. What is the pay you are offering for an inspector?

Mr. WYATT. Depending on the experience level, the entry level is very minimal. It is usually a GS-5.

Senator MELCHER. What is that? How many dollars?

Mr. WYATT. I don't have a pay rate schedule with me.

Senator MELCHER. I am sure there are a lot of people in this room who can tell us.

Mr. CAMPBELL. About $12,000 a year.

Senator MELCHER. Now this is an inspector that is going to get $12,000. Is that what you are offering? I can understand why you don't have very many applicants that are experienced.

Mr. WYATT. I am speaking, sir, of those who have minimal or no experience by education or employment in the field. Higher grade levels, of course, are offered to those with greater background and experience.

Senator MELCHER. Give me an idea of how many you have recruited with experience.

Mr. WYATT. I would say that approximately 40 percent of our recent recruitment, approximately 45 people, have had significant degrees of experience in the operational and technical aspect. Of course, they have little or no background in the regulatory aspects. We have had to lower our standards a little bit because we could not compete with industry.

Senator MELCHER. Gentlemen, how much money are you getting now? What GS level are you?

Mr. CAMPBELL. About $21,500 a year, a GS-10.

Senator MELCHER. You are a GS-10. When you started working for USGS, were you experienced?

Mr. CAMPBELL. Twenty-eight years in the oil field.

Senator MELCHER. How many people with experience have you offered $21,000 to, Mr. Wyatt, at GS-10?

Mr. WYATT. I don't have any numbers on that, sir.

Senator MELCHER. Have you offered it to one?

Mr. HODEL. Senator, I would be surprised if he had offered it to any unless he had found somebody with the years of regulatory experience that George Campbell has. Based on what Mr. Wyatt has said so far, it does not sound as if we have had many applicants of that caliber and it would be a surprise to me if anyone had been offered that for an entry level position.

Senator MELCHER. I am going to find out more about this recruitment drive, which you say is essential, and I agree nothing is going to happen unless you have some inspectors out there to enforce these regulations, either existing ones or new ones, based on new legislation. But since, Mr. Secretary, you are using that million dollar a day loss in royalties figure it seems to me that there is a question of what is actually being done to plug this hole that you described—whether or not anybody has been authorized by the Department of the Interior to go out and recruit people at this level.

I, for one, don't think you are going to get experienced people at $12,000. I don't know why you would. It is sort of an entry level for somebody to get some training, but it certainly is not a level to attract anybody with experience.

So I am going to repeat this question in a different way. Has there been an effort by the Department of the Interior to attract experienced personnel by offering a level of pay somewhere near what would be required to match the experience involved?

Mr. WYATT. Certainly, Senator, those in oil who have this experienced background, that have met with the personnel requirements would be offered money commensurate with that experience.

Senator MELCHER. Is there a procedure under civil service where you list who you are seeking to hire and the qualifications and the commensurate pay? How is this done? How have you listed this in seeking to fill these spots?

Mr. WYATT. We have advertised.

Senator MELCHER. What does the advertisement say?

Mr. WYATT. In trade journals, seeking petroleum engineering technicians. It has been some time since I have looked at it personally. I don't remember the precise words, but certainly we are looking for people who are experienced in both drilling and the production phase.

Senator MELCHER. Does it mention the salary level?

Mr. WYATT. Yes.

Senator MELCHER. What is the salary level mentioned?

Mr. WYATT. Anywhere from about GS-5 through 9 or

Senator MELCHER. Does it specifically mention GS-10?

Mr. WYATT. I don't recall that specifically, sir.

Mr. HODEL. Senator, we should provide you a copy of that advertisement. It would be the normal procedure to identify the grade range and the salary level, depending on the level of experience and knowledge and qualifications of the applicant.

Senator MELCHER. Yes, I would be interested in having that. George, what would you feel would be the opportunity to hire experienced personnel—let us say somebody with 10 years at least—in the oil field or gas field activity at the GS-10 level?

Mr. CAMPBELL. On a personal note, I have been told that I am as high as I can go as far as step increases. A technician can go to a GS-10. I personally would like to go higher or I will go back to industry. Now, what I would like to see tried, is to have some knowledgeable people go into some of these oil companies and contact their technical people. There are some of those people who are my age and younger that I believe could pay a proper starting salary and give them an incentive. I really believe that we could probably find some people with Roy's experience and my experience.

In my office, MMS hired two GS-9 technicians. One man has about 25 years of oil field experience and the other man has 23 and they are very knowledgeable oil field types but, they need some regulatory experience. They need some schooling in regulation. This is one of those things that frightens even the experienced oil field personnel in coming into the Government—rubbing shoulders with all of these regulations, which are not easy to comprehend.

In the past we have been telling them to go to the field and do it and this is exactly what happened to my two technicians. They were told to go to the field and do it. About a month later they went to the school in Denver and received the technical training. We have everybody from GS-4 and 5 up to GS-10's in the school. So there are a lot of people that were getting some firsthand insight on Federal regulations.

Senator **MELCHER**. Who was running the School?

Mr. **CAMPBELL**. MMS.

Senator **MELCHER**. Who specifically?

Mr. **CAMPBELL**. Dan Gilliam and Mr. Baker out of Reston.

Senator **MELCHER**. How long a school is it?

Mr. **CAMPBELL**. It was 6 weeks and I understand in July the school will be reheld.

Senator **MELCHER**. Is it a good school?

Mr. **CAMPBELL**. Well, people have given many interpretations on what they thought the school was. In my estimation from my experienced people, the school should be broken up into parts of inexperienced and experienced people and then I think it would move much faster.

Senator **MELCHER**. In other words, you are saying somebody with no experience, however willing, has to go a little bit differently than somebody who has been 11 years in the oil field.

Mr. **CAMPBELL**. Yes, sir. The oil field speaks a different language and if you don't understand the terminology used as an engineer or a technician in the oil field and you are coming from another way of life, it is going to take you a year or so before you find out what we are talking about.

Senator **MELCHER**. Tell me this in regard to the first inspection after production. An oil well has to have a LACT unit installed to determine the amount of oil for sale. Does not that first day production then, through a LACT unit, require an inspector to be present to gage it or to set it, whatever the term is?

Mr. **CAMPBELL**. Yes, sir. Prior to that first day sale, the first production from that well, that operator would have to apply for permission or approval to install this LACT unit. Then when he had the LACT unit ready for use, a technician would go out there and inspect the installation to see if it was proper and up to the symmetric drawing that the company had sent in with their request.

The reason we need the first day production is because probably the district supervisor would give the operator permission to truck haul the production until it is ready to go through the LACT unit and this will allow him to have a method of monitoring the first production off of that lease.

Senator **MELCHER**. What will that first day inspection require of that inspector? Would the operator not have to tell him what the oil is, if it is oil, and how much water there is in it?

Mr. **CAMPBELL**. Yes, sir. That would be listed on the completion report, which shows the initial production of the well, and the percentage of water.

Senator **MELCHER**. Is that being done now?

Mr. **CAMPBELL**. That would be done at that time.

Senator MELCHER. Is that being done now?

Mr. CAMPBELL. No, sir. That is not being done. It is being implemented.

Senator MELCHER. When is that going to start?

Mr. CAMPBELL. Right now in our office we have not received any of the first month reports. We do not have any new wells completed in the Wyoming area right now. That is in my office.

Senator MELCHER. Under this new order that was mentioned here——

Mr. HODEL. The order was dated February 8, Senator.

Senator MELCHER. Has it been started.

Mr. CAMPBELL. We have not received any. You have to remember I am in a subdistrict office and if an oil company was going to send us a report they would probably send it to the district office in Rock Springs and then we would receive it from Rock Springs.

Mr. HODEL. Senator, it may be helpful to your dialog with Mr. Campbell for me to report that when Mr. Campbell and Mr. Harrison and I got together and began discussing some of these issues, I became concerned about the administrative processes by which they were receiving their directives and advice. In checking with the management at Minerals Management Service, I think both Mr. Campbell and I have been reassured that some of the procedural inadequacies which have been occurring are being very rapidly worked out.

The communication link was not good. I think Mr. Campbell could attest to that. And some of the directives dated February 8 may have been hung up in the district office or some place else in the system and were not received in the Thermopolis office from which Mr. Campbell operates.

I think that having identified that, we have taken very explicit action to correct it and I think some of these problems will be alleviated promptly.

Senator MELCHER. I am getting at a pretty basic point here; namely, whether or not these orders can be carried out with the number of inspectors you have. It seems apparent to me, at least, that they are not being carried out. Do I understand this order for first day reporting is in effect right now?

Mr. HODEL. Yes.

Senator MELCHER. As of February 8?

Mr. HODEL. What we are hearing is that it was not received or understood to be received or identified in the Thermopolis office. So, effectively, it has not been available to George Campbell and his associates until now.

Senator MELCHER. So, it is not being done right now?

Mr. HODEL. Not totally. That would apparently vary throughout the system. I think it is appropriate to comment here that as we have indicated, and as you well know, this is a very serious problem. It is a complex problem and it has gone on for a good many years.

When we came onboard, Senator, in the spring of 1981 one of the early things we were briefed on was the efforts that were ongoing by the conservation division of Geological Survey to correct the problem. We thought, well, that is wonderful; we are really pleased that that is going on. We received a briefing on an accounting system and it sounded all right to me with my background and the Secretary with his.

Then we began to hear rumbles that maybe this would not solve the problem—maybe this accounting system was only a piece of the action and that we would spend $200 million over the next 10 years imposing an accounting system and finding out our profit from it was very inadequate. That is when the Linowes Commission was appointed.

It went out and although it did not hold a large number of hearings, it did hold hearings, and it was conposed of a number of quality people, David Linowes, plus Elmer Staatz who had been Controller General and had been exposed to these kind of reports over the years, plus others, including the State geologist from Oklahoma, who certainly is a knowledgeable individual. The report of the Commission confirmed the suspicions that had been raised in our minds that this accounting system is only part of the action.

We are now in the process of building up the number of inspectors. That is an ongoing process and whether the number of inspectors we have identified is adequate, only time will tell. We are trying to streamline some of the procedures. We genuinely believe that a proper bill which gives us proper enforcement capabilities, will greatly assist the inspectors in the field to get the job done without some of the headaches that have been going on.

I am sure you have heard George Campbell's testimony yourself about situations where time and again we have issued the same kind of noncompliance letter to a company and the situation has not been corrected. We are wasting that inspector's time if he does not have some teeth with which to make something happen.

That is what we are trying to implement and I think with that kind of help we will find out whether 100 inspectors is enough, too many, or too few. It is not likely to be too many. If it is too few, we are going to have to continue to seek additional inspectors.

With regard to the pay level, I would expect, serving as the chairman of the Minerals Management Board, that the Minerals Management Service will advise us promptly if it turns out that the pay level is not sufficient to attract either the number or quality of inspectors that we have to have and that we will have to take a look then at what our options are and at the Government pay requirements and rules and see what we can do.

Senator **Melcher**. I think it is clear that if we put language in that requires first day reporting, we have to know what it means. It has to mean that the operator can go ahead and produce for sale. If it is to go into a truck, it means that the inspector must be there immediately. I think I am correct on that. Am I not, George?

Mr. **Campbell**. Not necessarily. The inspector would not have to be there. If it were a suspicious lease or a suspicious isolated area it would give us the first indication that we needed to monitor that area.

Senator **Melcher**. How would you know what the oil was in the truck?

Mr. **Campbell**. We would take our equipment along and gauge it.

Senator **Melcher**. If it is to be meaningful in order to start this whole procedure, you would have to be there with the first truck load. Would you not?

Mr. HODEL. I think you would have to be able to be there at the first truckload. I think that is the important thing. The point the Chair made earlier was that, if we had a strong notification requirement, George or someone from his office could go there because he had been notified.

Right now we don't think we are being notified. He cannot go out and check. We don't want to see any oil transported improperly and no payments made. If we lost a single truckload, it would be a minor seepage compared to what is going on today.

Senator MELCHER. You would take the operator's data on what the oil was and therefore how much the royalty would be. Is that correct?

Mr. HODEL. I assume that would be correct, yes.

Senator MELCHER. That would be the only way to do it?

Mr. HODEL. You have the option of sending the inspector out there.

Senator MELCHER. I understand that, but if you did not have the inspector go there then you would take the operator's data, would you not, Mr. Wyatt?

Mr. WYATT. Yes. I think there is another point of clarification. The first day of notification is within the next business day after. I think what I hear here, is one would have to require notification prior to the sales, so that one could be there when that first sale was consummated.

The way we are looking at it is as quickly thereafter. One then has the opportunity to get an inspector out there and verify that the circumstances are in accord with the requirements.

Senator MELCHER. And under any circumstance where the oil would go through a LACT meter, that would be the first day of production. The oil would not be produced until the LACT meter was approved and you would still have to have the inspection. Is that not true?

Mr. WYATT. That is correct. In placing this well in production, it is a new production facility, wanting to use a LACT certainly those aspects that George described a few minutes ago would have to be gone through before you can sell the goods.

If on the other hand it is an existing facility with an approved LACT and merely tying a new well into it, that would not necessarily require an inspector to be there the first time the well is producing.

The CHAIRMAN. I might just mention that the stop and search provision of this proposal is an outgrowth of that inspection, particularly where I have heard that it was after the first day of production and because you are giving permission in many of these instances to transport by truck the only means by which you can determine what actually occurred before you got there is by looking at what is in the truck. And I think there is no comparable provision in the existing statute to make clear to do that.

Mr. HODEL. That is correct.

The CHAIRMAN. That is found in sections 5 and 6 of the proposed legislation. So if permission has been granted to transport by truck, I suspect he does not necessarily have to be there at the time if there is some element of enforcement, because the operator knows that as that truck progresses away from the site it might be stopped and inspected for quantity and quality of oil and the inspector would have the authority to do so.

Mr. HODEL. It is a systematic approach, Mr. Chairman, which ideally starts with the flow of oil from the well and follows it right on through the books of the company or companies receiving the oil. It is only by checking both of those that a limited number of people and a limited expenditure system can hope to catch or identify all of the royalty that we should be collecting.

Senator MELCHER. You are depending on the civil penalty primarily and almost exclusively to get compliance. Are you not?

Mr. HODEL. Senator, yes, and partly in my case that is because of disappointment at the level of criminal penalties that have been imposed in those cases that we have successfully brought to prosecution or provided information on for possible prosecution. We have found that the criminal court has been relatively reluctant to impose either imprisonment or significant fines. Therefore, even if we believe that we can show or prove fraud, it is not much of a deterrent when you look at the values that are involved here.

Senator MELCHER. Have there been any cases where you have found fraud or willful malfeasance?

Mr. HODEL. I believe that the only convictions, and I will ask to be corrected if I am not correct, that we have had have been convictions for theft, which appears to us, to be one notch above fraud or below, whichever direction we are running the scale.

Senator MELCHER. In regard to the site security plan, sites vary so much for Federal leases in particular. There are many instances where oil produced is in the field, as in the case of Elk Field, where the wells are either very widely spaced or very close together so that it is extremely difficult to tell where the Federal lease begins and where it ends. The oil is going to be removed from the Federal lease to a central point which, in almost all instances, is off the Federal lease. A large percentage of the cases involve federally leased oil going either through a private lease or state lease or onto to another Federal lease where the oil will be treated. What kind of site security are you talking about in that sort of instance?

Mr. HODEL. As you well know, the proposed Statute provides that the Secretary can set minimum standards. The reason for nothing more specific than that in the bill is so that a company can refine its system of site security.

I would have to ask in the specific case you mention how it would be accomplished. We all know what the objective is. Now, how do we tailor that so it fits and is not an undue and unconscionable burden on the operator. If anybody is prepared to comment on that particular case, I would ask him to do so.

Mr. PENDLEY. Mr. Chairman and Senator, we are at this time engaged in a Federal Register notice with regard to site security procedures. That Federal Register notice expires on the 21st and we will probably extend the commenting period. We are soliciting comments as to the precise way in which we should go about this matter of site security.

Senator MELCHER. Do you have any idea on how to do it, Mr. Wyatt?

Mr. WYATT. First of all, let me correct something Mr. Pendley said, it was the 21st of April and not the 21st of this month that we filed this notice that was published in the Federal Register. The reason we gave it the 30-day comment period, Senator, is that we have had numerous requests that we extend that time frame. We should have a notice in the Federal Register this week.

It is going to be as you surmised a rather difficult task to tailor the standard set of the minimum requirements that would be equally applicable nationwide to all of the operations, and we suspect at this point that we will have to have some subsets to those being applicable in a given area.

We have had posed a number of questions in the Federal Register notice that we are seeking comments on. We have a task force formed involving both experienced people here and experienced people in the field to put together that proposed road map. And we certainly intend to fold into that, of course, the concerns expressed by the Linowes Commission recommendations and more particularly those concerns developed by the quality assurance team.

Senator MELCHER. What is the quality assurance team recommendation, George?

Mr. HARRISON. I think we have gone with limited access to the sales point or to the storage tank. Let a company submit their regions or how they are going to limit access to it and then let WMS approve a person to go through it.

Senator MELCHER. Where would the site security start, for instance, on the lease we visited together? Wasn't it a Union lease? I am thinking of the Union lease where the driver was going to remove the oil up to another site a couple of miles away.

Mr. HARRISON. That is the Commodore lease.

Senator MELCHER. How would you start site security there, because the Federal lease is right there?

Mr. HARRISON. We could limit access to the loading point.

Senator MELCHER. Which is the tank.

Mr. HARRISON. Yes, sir.

Senator MELCHER. What effect would that have?

Mr. HARRISON. It would cause unauthorized people a problem getting in, if they did not have a key to the gate.

Senator MELCHER. It would be an offense?

Mr. HARRISON. Yes, sir.

Senator MELCHER. It certainly is not an offense now.

Mr. HARRISON. No, sir.

Senator MELCHER. How would we have site security, for instance, where oil is just stored in either a cement tank or in an earth tank where anybody could back up with a truck and pump the oil out of the pond and take off with it?

Mr. CAMPBELL. Senator Melcher, it is unlawful to store oil in an earthen pond. This is the problem we are addressing right now. The solution is to upgrade the facility that treats the oil so that there will not be any oil in that pond.

Senator MELCHER. Would there be a problem with cement pits then?

Mr. CAMPBELL. If they are going to sell the oil they would have to put it in a strapped tank.

Senator MELCHER. In other words, they would not use the pond?

Mr. CAMPBELL. Yes, sir.

Senator MELCHER. Well, that is so commonly done now.

Mr. **Campbell**. That is what we are attempting right now in Wyoming to get rid of the pits. And if they do have oil in the pits they will have to upgrade their facilities. Then if they have an emergency spill their plans will notify us of what they will do with the oil.

Senator **Melcher**. Is this being implemented now, no pits?

Mr. **Campbell**. No. It started in the Casper area.

Senator **Melcher**. Mr. Wyatt?

Mr. **Wyatt**. Yes, sir, I would be happy to comment on that. We do approve pits for temporary or emergency use under appropriate circumstances for water disposal purposes. We do not approve pits for the storage of crude oil, although we fully recognize that despite due care and dilligence on the part of our operators, there can be cases in which oil gets in the pits.

Unfortunately, we are concerned now that due care and dilligence is not being exercised properly and that oil is getting in the pits, which should not be.

Senator **Melcher**. Which oil would that be that should not be in the pits?

Mr. **Wyatt**. We are concerned that in some cases, Senator, the production facilities that are provided are inadequate to handle the production stream, particularly in instances where the water production is very high and that the oil is being carried over with the water. We think there are instances in bleeding, in necessary operations, in bleeding off the tank bottoms or bleeding too much really good oil to the pits.

Senator **Melcher**. It is so commonly done that what you are saying is that you are going to move toward regulations that prohibit storage of oil in the pits?

Mr. **Wyatt**. We already have and have had for a long time in effect a notice to the lessees and operators MPO 2-C, which specifies that the operators are expected to keep those pits approved for water disposal purposes, essentially free of oil. We have, as you know, an interim NTL 7, which talks in terms of removal of crude oil from leases by means other than a LACT.

We have finalized that within the last week or 10 days and it should be appearing in the Federal Register this week. And it does address this issue, in which it says that lessees and operators are expected to maintain equipment on the leasehold that is suitable for handling the production that they are involved with. And that reiterates the fact that we do not approve pits for storage of oil.

It states for the purpose of our requirements that they will be expected to recover that oil that goes to the pits through the existing facilities back into storage for sale. And then if it is construed to be in such a condition that they cannot treat it with their existing facilities and maybe they propose to dispose of it in another way, they must contact the appropriate district supervisor to get his permission and he must make that notification in time to allow us to be there if we desire to be there to witness the removal of the crude oil in that manner.

Senator **Melcher**. To go back to Elk Hills area where the oil is taken off the Federal leases and is commingled with private oil or State oil or all three, what do you do about those pits? I have seen one series of pits in particular that I am visualizing in my own mind, I have seen it twice now, where the oil is in three different pits and can flow between the three pits. I believe either one of them is Federal and two are private or two are Federal and one is private. Is that right, George?

Mr. **Harrison**. Two Federal and one private.

Senator **Melcher**. Two Federal and one private.

Mr. **Campbell**. Yes, sir. Senator Melcher, this Federal oil was being trucked over to the private lease to what we noticed was probably for sale and I think that is the reason. Now this site security——

Senator **Melcher**. Repeat that again, the part about the oil for sale.

Mr. **Campbell**. Yes, sir. As we view this lease, it appeared that this Federal oil was being trucked, in fact the truckdriver told us, that this Federal oil was being trucked over to that private lease and pumping it into sales. The site security problem on that particular area is going to need attention. It is really going to give people trouble, because those leases are so close together. They are all commingled, as you saw. And I would not touch site security with a 10-foot pole on that lease, because it is going to be tough to have site security.

And I don't intend to jump back and forth between regulations, but as an industry-oriented technician, those people are going to have to have those pits or they are going to have to be taxed to have oil. That is a steam flood. There is no way that oil can be separated from that body of water.

So site security is going to be very important. That is one of the reasons that we need penalties. If they are not going to handle that oil properly, we must have a penalty strong enough that they will not do it but one time.

Senator **Melcher**. Keeping those particular pits in mind, that series of three, two Federal and one private, where they flow back and forth——

Mr. **Campbell**. Those should be separate.

Senator **Melcher**. Those should be separate. That is number one. Has it been done, do you know?

Mr. **Campbell**. Not that I know of.

Senator **Melcher**. Has it been reported?

Mr. **Campbell**. Yes, it was reported. That is my understanding.

Senator **Melcher**. At what stage?

Mr. **Campbell**. All I know is that they fined them $10.

Senator **Melcher**. That was after they saw it the first time?

Mr. **Campbell**. Yes. I do not know what happened after——

Senator **Melcher**. It continued, because 3 months later I was there and they were still doing it.

Mr. **Campbell**. That is slightly out of my area.

Mr. **Hodel**. Senator, I would expect that an extensive review of what goes on in the field would identify that there is a bell curve of activities going on out there. There are a limited number that are very, very easy and quite a wide number that could be covered by some standard type site security requirement.

I suspect also from your colloquy here and again what you have seen in the field that there will be a large number of exceptions that have to be provided for. Again, approaching this in a sound management mode, the first thing we need to do is try to at least get under control those areas for which site security is relatively simple and easy and recognize that the proposed bill would provide that minimum standards shall take into effect a variety of circumstances prevailing at lease sites We might end up with some areas, I suspect, from what Mr. Campbell has just said and what you have seen, for which we can't devise a minimum site security plan without an extended cooperative agreement with the State and the oil company.

Here again, I would hate to see this program delayed or sidetracked because we cannot answer the question precisely of how we will deal with every last well or pit. I know that is not what your intention is either. But what we need to do is to be able to move forthrightly in those areas where we can clearly see something needs to be done and we can relatively simply and straightforwardly develop an acceptable site security plan.

Senator MELCHER. Well, not only that, I think we have got back to the point that in the district offices, there are simply not enough inspectors. And I will ask this question, how many inspectors are in Bakersfield?

Mr. WYATT. I believe that number is six, but I would like to verify that.

Senator MELCHER. Six inspectors and there is probably a production of what, I don't want to count it, but we must be talking about a production of 200,000 or 300,000 barrels a day other than Elk Hill, are we not, in that area?

Mr. WYATT. Several thousand, Senator, and about 350 producing leases.

Senator MELCHER. Several thousand. I would use the figure of 200,000 or 300,000 barrels production there and I know that would not all be Federal. About how much would be Federal?

Mr. WYATT. I will have to supply that. I don't have it precisely.

Senator MELCHER. There are six inspectors in that jungle out there. Even if they worked 7 days a week, and I don't think they do, do you have any program where anybody works on the weekends?

Mr. WYATT. Certainly, we have authorized overtime and working on the weekends.

Senator MELCHER. But there is no program for weekend inspections now?

Mr. WYATT. I beg your pardon, sir.

Senator MELCHER. Is there a program for weekend inspections?

Mr. WYATT. Not as a routine basis.

Senator MELCHER. So if you wanted to do something irregular, the best time to do it is on the weekend.

Mr. WYATT. I am saying that we don't routinely carry out inspections on the weekends, but we have and continue to do so on a random basis.

Senator MELCHER. If one of those pits were pumped full of oil, would they have a run ticket?

Mr. WYATT. I have no way of knowing.

Senator MELCHER. Are they required to have a run ticket by regulation?

Mr. WYATT. Yes.

Mr. **Hodel**. But if they failed to have a run ticket, the penalty is very, very slight.

Senator **Melcher**. I understand that. But what is not being said here is that under existing law the threat of shutting down a lease is a pretty profound threat. And while it has never been exercised, as far as I know, unless you started to exercise it on the Wind River last week.

Mr. **Hodel**. Senator, it has been exercised on a number of occasions, 18 times in the last year and it is a composite total—18 times since January 1, 1982, and over 200 times since October 1980.

Senator **Melcher**. Then the next step of canceling the lease?

Mr. **Hodel**. I have the letter, by the way, that you asked for earlier, Senator.

[The letter follows:]

United States Department of the Interior

OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

MAY 12 1982

CERTIFIED - RETURN RECEIPT REQUESTED

Mr. David G. Wright
Division Production Manager
Amoco Production Company
Amoco Building
17th & Broadway
Denver, Colorado 80202

Sohio Petroleum Company
50 Penn Place, Suite 1100
Oklahoma City, Oklahoma 73118

Gentlemen:

The purpose of this letter is to inform you that I have considered a petition to cancel two leases held jointly by Amoco and Sohio Petroleum Company, which was filed by the Shoshone and Arapahoe Tribes on November 16, 1981. The leases in question, lease #I-96-IND-000299 and #I-96-IND-007651, are located on the Lander Field of the Wind River Indian Reservation. Copies of the petition have been made available to you. I have also considered a statement of Amoco in response to the petition, dated February 8, 1982; a supplemental statement of Amoco, dated February 8, 1982; a preliminary statement of Sohio, dated February 25, 1982; a reply of the Shoshone and Arapahoe Tribes to the statements of Amoco and Sohio in response to the petition, dated February 25, 1982; a report on the petition from the Office of Trust Responsibilities, Bureau of Indian Affairs dated March 9, 1982 and two reports of the Minerals Management Service, dated February 26 and March 19, 1982. Copies of these reports are attached.

The petition describes certain actions and omissions on the part of Amoco and Sohio, which if factually correct, constitute violations of the terms of the leases and the Department's regulations. These actions and omissions include: failure to pay the Tribes their correct royalties as required by 25 CFR 171.13 and 30 CFR 221.18, USGS Notice to Lessees and Operators of Indian Oil Lease (NTL-IA) at pp. 5 and 8, and the lease provisions in ¶ 2(e) of lease #299 and ¶ 3(c) of lease # 7651; failure to keep accurate records and submit accurate monthly reports to the USGS regarding production, sales and royalties on each lease as required by 25 CFR 171.18 and 30 CFR 221.60, 221.62 and 221.63 and NTL-IA at pp. 6-11, and ¶¶ 5 & 10 of lease #299 and ¶¶ 3(d) & 3(g) of lease # 7651; and failure to comply with various oil and gas operating regulations found in 30 CFR Part 221 and 25 CFR Part 171 and the leases themselves.

Based upon the record before me I have concluded that the allegations presented by the Tribes are true and that such allegations warrant cancellation of the leases. Accordingly, you are hereby notified that Amoco and Sohio have 30 days from receipt of this letter within which to request a hearing to show cause why their leases should not be cancelled. If a hearing is requested, the matter will be referred to the Office of Hearings and Appeals for the appointment of an administrative law judge who will supervise discovery as provided under the Administrative Procedures Act, 5 U.S.C. §§ 555-556, conduct a hearing on the record in accordance with 5 U.S.C. § 554, and make a recommended decision for my consideration.

Sincerely,

Ken Smith

Assistant Secretary - Indian Affairs

cc: Mitchell Rogovin, Esq.
Rogovin, Huge & Lenzner
Attorneys for Shoshone & Arapahoe Tribes

Robert B. McCaw
Wilmer, Cutler & Pickering
Attorneys for Amoco

Paul R. DeStefano
Stefano & Harris
Attorneys for Sohio

Senator **Melcher**. Has there been a lease canceled, Mr. Wyatt?

Mr. **Wyatt**. No, sir. May I correct also the currently onboard inspectors in Bakersfield are seven and ongoing recruitment for one.

Senator **Melcher**. Let me get the latter part.

Mr. **Wyatt**. Seven onboard now and we are currently recruiting one additional technician.

Senator **Melcher**. Is the current penalty for not having a run ticket being set by regulation?

Mr. **Wyatt**. There is not truly a penalty, sir. We have no penalty provision under the current onshore Federal legislation. All we have is the right to recover additional administrative costs incurred by these violations. And the Secretary is absolutely correct, these are very minimal now. Although we do have new 221 regulations, that is 30 CFR 221, which substantially increase the size of the liquidated damages that would be imposed for various violations.

Senator **Melcher**. The penalty under existing law for not having a run ticket or any other violation of the regulations could be increased, could it not? What is the limit?

Mr. **Wyatt**. Well, if we have the pending penalty legislation, certainly.

Senator **Melcher**. No, I mean under current law.

Mr. **Wyatt**. Well, the amount of additional administrative costs that we expect to incur in the assessment will be going up significantly as soon as our new 221's are promulgated.

Senator **Melcher**. Under existing law?

Mr. **Wyatt**. Yes, sir.

Senator **Melcher**. That could have been done in the meantime.

Mr. **Wyatt**. Yes, sir.

Senator **Melcher**. What would involve the penalty going up?

Mr. **Wyatt**. Give me a moment. They range between $100 and $250.

Mr. **Hodel**. These are liquidated damages for our administrative costs and if we sought to collect an excessive amount, would presumably be limited by a court to that amount of our administrative costs that could be proven.

Senator **Melcher**. It could go up to $250.

Mr. **Hodel**. If we could show those costs.

Senator **Melcher**. Just to make it clear. In this Bakersfield system we are talking about, it is necessary to heat the water to make steam, injecting it into the well to get this heavy oil out. So some of these trucks pulling up to a pit may be doing it for that very purpose, I would assume, to take this mixture of oil and water to a boiler to heat the water for steam to be injected in the well.

Now that is permitted, but the point is I don't know how anybody knows whether or not that truck that is backing up to these pits is going to do that or is going to go somewhere else. Judging from the answers I have gotten there would be no way of telling with seven inspectors there.

You would have to assume that one was not going for that purpose, that it is actually for sale somewhere else. Is that correct, Mr. Wyatt?

Mr. **Wyatt**. I would agree with that, sir.

Senator **Melcher**. That brings me to this point. Is it proposed in the administration's bill or is it in somebody else's bill to charge royalty on oil produced even if it were to be used for the purpose of boiler generation of steam?

Mr. **Hodel**. That is correct.

Senator **Melcher**. Would that not be self-defeating since that is a necessary procedure to get the oil in the first place?

Mr. **Hodel**. I think it would be strictly a matter of the cost accounting conclusions. If it is economically effective, it will be done and if not we have the authority to relieve the requirements. If it turns out, for instance, that it costs too much in royalty to use some crude from the well to boil and clean the oil, or to separate the oil from the water in these steam injected wells that you have been talking about, then presumably a relief request will be submitted and I suspect that any reasonable process will result in a relief.

But under the present process, we have no knowledge or control over the amounts that are used and it seems inappropriate to us.

Senator **Melcher**. Well, as I understand it, that oil is coming out of the ground as 50 percent water. You not only have to get rid of the water down to an acceptable level that would be less than 2 percent—that's about right—and then also it would mean to lift the oil out, you have to inject the steam.

So we have got two boiler functions. One boiler function to heat the water for steam to get the oil out in the first place and then the second is to use oil to heat the boiler to boil off the water so you can sell the oil. So it seems to me that if you want the authority to modify leases, you are going to have all of those Federal leaseholders in a quandary out there wondering what is going to happen. The amount of oil they lift out of the ground depends on, first of all, injection of the steam into the heavy oil deposits in the ground and then boiling off the water after you get it out.

Mr. **Hodel**. Senator, I don't see that they will be in any particular quandary. I think it is a matter of simple, economic analysis. Is it worth doing for the oil they can recover at the cost of paying the royalty to the Federal Government, either on the Indian or the Federal oil that is being pulled out of the ground?

The problem is that it is Indian or Federal oil which is being pulled out of the ground and under the rules we are charging a royalty on the value of the oil that is being produced. It certainly cannot be said it is not being produced when they pull it out of the ground and burn it.

We think we are entitled to the royalty. If it turns out that this renders the process not cost effective and that can be shown, I am confident that adjustments will be made, but I think that showing has to be made and I think it would be difficult in many cases to make a showing that royalty charge would be the difference between an economic recovery system and a noneconomic recovery system.

We certainly believe we are entitled to collect the Federal royalty on oil which is pulled from a Federal lease.

Senator **Melcher**. As a general practice though, in that particular field, I think you would have a very difficult time demonstrating to the satisfaction of the operator that you could go backward on leasing, No. 1, on the existing lease, where at least it is already in, et cetera.

No. 2, it might cut down on the interest in Federal leases if that were promulgated and required, because I don't believe it is required on State leasing. I cannot speak for the State of California, but I think that both private and State lessors envision that the operation can use whatever oil is necessary to heat the water to get to the steam to inject the oil to begin with and then, secondly, to use whatever oil is necessary to heat the boilers to get rid of the water from the oil that is going to be sold.

I think it is a rather common practice. We need to look at this and know where the private or State leases have contrary provisions. It is a very practical point in that particular field.

Mr. **Good**. I am not sure, Senator, that there is a uniform contract provision in the State and the private practice. It is my understanding that there is not such a provision and the States do fluctuate and I have no rundown on what the various States require in their contracts as far as the user in this type of oil and gas. We could run that down and submit it for the record if you like.

Senator **Melcher**. The same would be true then in a gas well where it is the usual practice in coal country to heat whatever facilities there are in the way of buildings.

Mr. **Hodel**. The only exception would be reinjected gas or flared gas with a permit.

Senator **Melcher**. Flare gas would be for safety purposes. Is that correct?

Mr. **Good**. I am not sure it would be limited to that. I think that is what we had in mind when we drafted that provision.

Mr. **Hodel**. The proposed statute would be flared gas with prior approval from the Secretary without specifying the purpose of the flaring.

Senator **Melcher**. You have a copy of this letter signed by Assistant Secretary Smith?

Mr. **Hodel**. Yes, sir. You asked earlier, Senator, what the effect of the letter was. The last paragraph makes it plain that Assistant Secretary Smith has concluded that the allegations presented by the tribes concerning these companies were true and that the allegations warrant cancellation of the leases.

He gives the companies 30 days within which to determine whether they will show cause as to why their lease should not be cancelled and then lays out the procedures of the hearing as requested by the companies. This letter is an excellent example of a number of situations. First of all, the fact that we are increasingly attempting to bring to bear whatever resources we have to collect the royalties.

Second, the wrong parties are being punished here in that closing. Cancelling these leases may mean that production from those wells is stopped for some period of time and that the tribes involved will be deprived of their cash flow, if not the ultimate resource, which they presumably still will receive eventually down the road, they are being deprived of the cash flow which could be of great significance to them.

It is precisely the kind of thing that I think illustrates that, whether we have enough inspectors or not, we need to give them the right tools.

Senator **MELCHER**. This is the first time that this procedure has been used. This is the first step in cancelling the lease, is it not?

Mr. **HODEL**. This, to the best of my knowledge, is the first time, Senator. I do not know for sure that it is the first time. It is on an Indian lease which differs somewhat from the shut-in reports that we have been talking about, of course, because they don't terminate the lease.

Senator **MELCHER**. The shut-in reports are just to stop producing until something has been corrected. Correct?

Mr. **HODEL**. Correct.

Senator **MELCHER**. Now, since 1980——

Mr. **HODEL**. October of 1980.

Senator **MELCHER**. October of 1980. Since the end of 1980 over 200 temporary shut-ins have been ordered. Is that correct?

Mr. **WYATT**. Yes, sir.

Senator **MELCHER**. And this is the first time the procedure to actually cancel a lease has taken place.

Mr. **WYATT**. It is not the first time recommendations have flowed in this respect, but to the best of my knowledge it is the first time that any case has ever proceeded to this point.

Senator **MELCHER**. For cancellation of a lease?

Mr. **WYATT**. Yes, sir.

Senator **MELCHER**. And the companies can file their administrative relief through an administrative law judge, as I understand it.

Mr. **HODEL**. Yes.

Senator **MELCHER**. Now, the determination of the administrative law judge will be final as far as cancelling the lease. Will it not?

Mr. **HODEL**. He would conduct a hearing and make a recommendation to the Assistant Secretary under the procedure that is spelled out and the Assistant Secretary would reconfirm, but thereafter if there was an allegation that the procedure was erroneous it could then go to court. So this by no means is necessarily the last act in this particular activity.

Senator **MELCHER**. Might I return to this issue of use of oil or gas on a lease for the production of the oil or gas, which is amending the 1920 act. Under what circumstances was this particular amendment recommended?

Mr. **HODEL**. It was not a recommendation of the Linowes Commission, Senator. It was a result of our concern that we collect the royalty, as we understood it to be our obligation and responsibility on all gas developed or oil produced or saved on a lease. This will clarify the potential argument that would arise if we attempted to impose that now without legislation.

Senator **MELCHER**. In the case of heavy oil, none of the oil that is used on the lease or off the lease that involves reinjecting the oil has ever been reported on your monthly report in the 9-329 reports.

Mr. **WYATT**. I have not personally seen any of those, but the disposition of that crude oil, whether it is sold or used for other purposes though, should have been reported on the 9-329.

Senator **Melcher**. I wish we had somebody here from that Bakersfield office that could answer that. But it was my understanding that it was never reported, since it was used for either purpose, either heating the steam to reinject the oil or going through the process of boiling off the water.

Mr. **Wyatt**. That might be entirely correct, sir. As I said, I have not seen any of those reports myself. I do know that these other dispositions are to be reported on the 9-329.

Senator **Melcher**. I would like to know just what kind of a problem this poses. Can you enlighten me any further on that? Mr. Good, do you have a point on that?

Mr. **Good**. We were just comparing what the original language which we had suggested was and there has been a change to allow for the Secretary to permit reinjected gas to go without charging any royalties.

Senator **Melcher**. Reinjected gas.

Mr. **Good**. Correct. It does not change our suggestion with regard to lost, removed, or other oil and gas which is used for exploration purposes.

Mr. **Hodel**. And while Mr. Good is making that point, I need to clarify an earlier statement. I think I indicated that we would have some flexibility as to whether we collect royalty on oil used on the lease and I do not believe the language, as proposed, provides that flexibility. It is mandatory and that would raise the specter of the very thing you have asked about Senator, that by imposing a royalty which is too costly, would it make the well worth continuing to operate with the cost of all the heating, reinjection, and separation and the like.

Under the provision as written, we might actually cause some production to be shut down that would not otherwise be shut down. It would be better if we had some flexibility there so that we are in the position to provide relief in the event it would jeopardize production. Our objectives in the oil and gas program include both the provision and the appropriate claim to the Government for the receipt of royalties.

Senator **Melcher**. One of the problems that has been clearly demonstrated throughout the past 2½ years, has been the lack of uniformity in enforcing the regulations in the various regions and then in the districts, et cetera.

What is there about this legislation that corrects that problem? I don't think the legislation is necessary to correct it. Maybe you could answer it twofold and tell me what is being done now without the new law and if the new law is necessary to do the same thing.

Mr. **Hodel**. I think the issue of uniformity is one which does not require legislation. That is an administrative and a management problem, which has just not been dealt with over the years and, candidly, as we increasingly try to take hold of the Minerals Management Service and this whole process, we find that it is, as you have illustrated by some of your questions, very complex. It is a multi-faceted industry.

There are the exceptions that you have pointed out in the basic field area that are one kind of problem. You have different kinds of problems in other parts. You have got large wells and you have very small stripper wells and a few-barrels-a-day wells and hundreds-of-barrels-a-day wells.

What we are trying to do administratively through both the training program and a tighter administrative control, plus a supervisory training program which is very nearly implemented, is to see to it that our people are trained to read the regulations that exist. This will be a step in the right direction.

You then have to have a feedback system and we have attempted to take some steps to see to it that, where we are not getting responsiveness in the field, we have an opportunity for the inspectors to bypass that district or subdistrict office and advise Reston and the Minerals Management Board, so that we begin to get an exceptions report where we will hear if things are not taking place.

What we are hoping is that through this kind of training and revised writings that go out to the people in the field we are going to improve that matter of uniformity. And it really is uniformity at the takeoff point, if you will; the objective that we are trying to achieve will be the same throughout.

But I am confident that what Mr. Campbell will do out of Thermopolis, Wyo., will not be the same as what will work for the inspector coming out of Bakersfield, Calif. He will have different kinds of site security problems and different kinds of operating problems and so when you say uniformity, I am sure you mean uniformity of point of commencement but thereafter it may vary depending upon the circumstances in the field.

What we need to stay abreast of, and here is where training and communication will assist, is where there are similar situations in the field we need to improve our ability for the people in the field to communicate as to how they are handling that situation.

As you know when you bring people together for training and they start communicating, sometimes the eyes just open wide and say, oh, I did not know that; I have been doing it this way. And that is where we start back toward treating similar situations similarly.

Now, you ask then how does this bill contribute to that. You may want to ask George Campbell or Roy Harrison how they would see it. They certainly have a very specialized interest in this kind of thing, because they have been out on the front lines living with this, as you well know. But I see this kind of a statute which brings together the definitions, the responsibilities, the authorities of the Secretary and the penalty provisions in one place as extremely important.

It says that this is the mandate for this system. Instead of a whole series of regulations and laws that have been developed over a good many decades to reach out for and be aware of and understand and correlate, along with, Lord help us, additional legal opinions on how they should be interpreted, we would have a beginning point, if you will, for this complete system of reporting from the beginning of the oil production right on through to the time of sale and the right and authority to inspect and the opportunity to impose penalties, which we think are meaningful, which would be a tremendous incentive.

I think we have to address the fact that if a responsible operator is trying to do a responsible job, and his competition is not doing that responsible job, the pressure on the responsible operator to meet the competition is severe. He is paying a penalty if he advises us of the first day of production and all he has to pay if he does not is a $10 fine.

I think for the sake of the responsible operator, we need to have this kind of system as well. He should welcome it, because it will mean his cut-throat competitor will be faced with some very severe penalties if he does not comply with the law.

Senator MELCHER. George and Roy, you are both on that quality assessment team. I understand there are currently about five people on the team, is that correct? Now on this question of what the team has found, outstanding among the findings was the lack of uniformity and enforcement, was it not? Or was it lack of understanding of the regulations?

Mr. CAMPBELL. The main problem we found was, as Secretary Hodel just stated, and I agree wholeheartedly, was the lack of communication.

Senator MELCHER. Communication. Between whom?

Mr. CAMPBELL. Between management and the district supervisor and lower. This was one of the main points we addressed in our final report. There was a point where the communication broke down——

Senator MELCHER. Where was the point where it broke down?

Mr. CAMPBELL. At the supervisor's level, giving the order to the man in the field who was dealing with the operator, what do we do next. I have stated many times that the confused people were those in the oil company and the technician. The oil company did not know what we wanted and we were not quite sure what our supervisor wanted.

Senator MELCHER. When you say technician now, you mean inspector?

Mr. CAMPBELL. Yes, sir.

Senator MELCHER. In other words, what one inspector might say was necessary for the operator to do would not necessarily be what the supervisor said was necessary?

Mr. CAMPBELL. Yes, sir. It varied from area to area.

Senator MELCHER. It varied from area to area. This is the supervisor of a district office. Is that correct?

Mr. CAMPBELL. That is correct, sir.

Senator MELCHER. Whom do you blame that on, the supervisor or the inspector?

Mr. CAMPBELL. I think it was the consensus of the QA team that there was no communication between Reston, down to the bottom level.

Senator MELCHER. Through the supervisor?

Mr. CAMPBELL. Yes, sir.

Senator MELCHER. Through the region?

Mr. CAMPBELL. Yes, sir. Going down and coming back, the communication was not there.

Senator MELCHER. So the attempt to correct that, which is not necessarily in the legislation, is really a reorganization of the procedure?

Mr. **Campbell.** Well, I think that the Reston office is trying to get the procedure down to where the communication can start. That is what is necessary at our level.

Mr. **Pendley.** Senator, if I might speak to this, this was the problem when we came in, when we took over this massive charge that the Linowes Commission had laid before us. Communication was a prime concern. Mr. Campbell makes a point with regard to industry on one side and the inspectors in the field or the other.

Shortly after we received the Linowes Commission report, Secretary Watt signed a letter to all operators, lessees and operators, informing them of his intention to be tough and aggressive with regard to the requirements of the regulations and to demand of the individual operators that they be responsible solely and primarily for site security.

In addition, I delivered a memo from the director when I was Acting Director of MMS to each of the regional minerals managers, informing them of our intention to be tough with regard to enforcement activities, to be firm and to be fair in our implementation of the regulations and to be aggressive in that exercise.

During the training class we conducted in Denver, I flew out to Denver and made a personal appearance before these 35 inspectors and informed them of the basic message that they had the backing of Washington, that they had the full support of the Secretary to be aggressive in the field.

In addition, we are going to have, as the Undersecretary has indicated, a training session for our district supervisors to insure not only that our people in the field know how we want them implemented but our district supervisors be informed as well as to the procedures that we want enforced. We hope to have the rest of our inspectors taken care of later on this year.

But we are trying to get that line of communication opened up and to get that message down, right out into the field, right into that truck that goes out onto the lease site, of the role we want them to play in implementing the Linowes Commission's recommendations.

Mr. **Hodel.** Senator, I think we face a great risk at this time. The Linowes Commission report focused attention on how severe a problem we had. Your hearing helped focus attention on how severe a problem we had. The Secretary acted decisively and created the Minerals Management Service and said we adopt the Linowes Commission recommendations across the board. We are not going to quibble; we are going to carry forward; we ane going to move those into effect administratively and legislatively. We will seek what is necessary to carry them out.

I suspect that there will be people in industry today who would like not to have to face the kinds of penalties and the kinds of consistent, systematic approach we are seeking in this statute. And I think that they will try to persuade us that delay is appropriate, that we should study this much more carefully or that the months that have been spent in this effort in your hearing and the months before the Linowes Commission are not enough time to consider all of the things that are going on.

I fear that if they are successful in causing delay to take place that we will be sending people out in the field without even a pop gun in terms of effective penalties or sanctions to cause to be done what has to be done if we are ever to have a prayer of having an effective royalty management system.

That is why I welcome the opportunity to be here today, Senator, because I know of your concern and I know that we need that kind of help to move this program forward.

Senator **Melcher**. I don't think there is any doubt that the companies involved have had theft of oil or gas, although it is difficult for me to understand how they could steal gas. The companies are very anxious that action be taken to alleviate theft of oil, which would be actually to their advantage, because if the oil is sold to somebody, there are a few cases that have shown what has happened. No matter who gets the money royalty, whether it is the Federal Government or an Indian tribe or the State's share of the Federal royalty, seven-eighths of it still belongs to the companies.

Anything that is done to alleviate theft obviously they want done. I am well aware though that if all we are doing is passing new language but if the new law does not really get down to the basics of how you do account for the oil, we are not really accomplishing what we would like to do.

I think we have to review what the quality assessment team found to be lacking. I will list some of the findings I know to be true and I will not have to ask Roy or George to confirm this, because I know it to be true, are: the lack of uniformity of inspection, the lack of inspection, the lack of trained inspectors, the lack of any inspection, and enforcement of the regulations. Inspectors are not being backed up when the inspector writes out these incidents of noncompliance and they get their wrists slapped by the supervisor or somebody in the regional office.

They are probably not going to be writing out incidents of noncompliance very often after that if they write them out and nothing ever is done to correct them. That is in effect like a cop writing out a traffic ticket and nothing is done on it, and no penalty is imposed. Pretty soon the inspector either does not want to work there or if he is working there, he does not want to write out incidences of noncompliance. So the whole system breaks down.

What I am wondering is, George, after being on this quality assessment team for well over a year, do you think you have accomplished what you set out to do?

Mr. **Harrison**. I think we have accomplished a considerable amount, Senator Melcher. One of things we have started in Albuquerque on June 1, addresses the question you asked; should we have more than one team, are we going to take this team on a trial basis. Our answer was to do it on a trial basis to see how it came out and take it region for region.

I think we have accomplished a considerable amount by having the team preparing the report and having Mr. Hodel act on our report. This is what they are doing now by trying to assist us in the way they are.

I do think, and this was covered with Mr. Pendley, that at some time in the future, maybe another team will go back and check and make sure that the things that were found to be wrong were corrected, in other words a followup team.

Senator MELCHER. Were either of you, because of your actions on the quality assessment team, ever subjected to harassment by your supervisors or by anybody?

Mr. CAMPBELL. I would not call it harassment. I would say I was isolated.

Mr. HARRISON. We had chicken pox for awhile.

Senator MELCHER. Chicken pox? You mean you were shunned?

Mr. CAMPBELL. We were considered as people making waves and others did not want to be necessarily around us.

Mr. HARRISON. We were not too popular.

Senator MELCHER. You were not popular?

Mr. HARRISON. No, sir.

Senator MELCHER. Are you both GS-10's?

Mr. HARRISON. Yes, sir.

Senator MELCHER. Do you have an annual report by somebody above you, a supervisor or what have you, on what your work was?

Mr. HARRISON. I received a letter from Mr. Pendley and a letter from Mr. Wyatt. I have not received my full appraisal yet, as far as my job interacting. I think there is a problem in mine whereby a lot of things were not in my job classification.

Senator MELCHER. Is this an annual event?

Mr. HARRISON. Yes, sir.

Senator MELCHER. And so far, this is May, for your work done in 1982, you have not had your annual appraisal or whatever it is?

Mr. HARRISON. I have not received mine.

Senator MELCHER. What do you call it? What is the term?

Mr. HARRISON. Performance rating.

Senator MELCHER. Performance rating. You have not received that yet?

Mr. HARRISON. No, sir.

Senator MELCHER. Have you, George?

Mr. CAMPBELL. No, sir.

Senator MELCHER. Isn't that rather unusual?

Mr. CAMPBELL. I had a letter that said my ob would be reported. The way I understand it is if you don't get a job appraisal you are considered absent.

Senator MELCHER. If you don't receive one, you are considered absent?

Mr. CAMPBELL. That is what I presume, yes.

Senator MELCHER. Mr. Wyatt, can you enlighten me on this? It seems like when a couple of inspectors are selected for particularly responsible work on the quality assessment team, that should say that their work was more than adequate in the record.

Mr. WYATT. Certainly, sir. In selection for this sort of a team, obviously we were not looking for winning any popularity contest of the people in the field. We were interested in getting the facts and I think the team did an excellent job in that respect.

Our responsibility at national headquarters was one of rating the performance of the individuals on the team from the standpoint of their performance on the team. We have done so. In fact, if memory serves me correctly, we rated George and Roy, and they were both rated as excellent.

Senator MELCHER. That will be part of their permanent records.

Mr. **Wyatt**. Yes, it will. What needs to be folded into that is the rating of their immediate supervisors in their regularly assigned positions, for their total performance rating over the rating period.

Senator **Melcher**. Mr. Wyatt, do you believe the quality assessment team should again review what has happened since they made their assessment in the various regions and in the various districts?

Mr. **Wyatt**. I am certainly a believer, sir, that we must have the quality assessment program. Whether we reconvene the former team or establish that as a permanent function working for the director of MMS, or establishing a standing group in that respect, I don't think that has quite been worked out. Yes, we must have a continuing assessment.

Senator **Melcher**. Do you believe that the top GS rating for an inspector should be held to a GS-10?

Mr. **Wyatt**. No, sir, I do not.

Senator **Melcher**. Have you made that recommendation?

Mr. **Wyatt**. In fact we in MMS are working on the package now, which we hope to submit to OPM or to the Department and then to OPM for relief, because we recognize there is a salary disparity between what we are able to offer these people and what industry can offer them for comparable jobs.

Senator **Melcher**. That disparity, would it not range somewhere between $10,000 and $15,000 a year?

Mr. **Wyatt**. For very experienced people, yes, sir.

Senator **Melcher**. If you can attract somebody in industry to become an inspector, would it not be the type of job you would expect to probably last the whole working career of an individual?

Mr. **Wyatt**. Yes, sir.

Senator **Melcher**. I think that speaks for itself. Mr. Secretary, among the recommendations or discussions, I think that would be the term, of the Linowes Commission, was the recommendation that outside firms do contract work. Let me state that I don't know that I would agree with that myself, for the Secretary to contract with somebody outside for auditing the minerals or other kinds of services done for royalty management.

Since there is a considerable doubt on how royalty accounting has been handled over the past 25 or 30 years, what about the General Accounting Office, which is a branch of Congress, conducting periodic audits, once a year or so, something of that nature?

Mr. **Hodel**. Senator, I think the responsibility of the General Accounting Office is fairly well established and that that ought to be the kind of thing it does, which is to look over the shoulder of bureaus and agencies and departments to see that they are carrying out the job the way it ought to be carried out.

I think the job of our Inspector General is to look over the shoulder of the Minerals Management Service to make sure that it is carrying out the job the way it ought to be carried out. Then we have the further question of who is going to do what we have been calling look-back audits, which amount to catch-up audits of the oil companies, the producers over the last number of years.

It was concluded that it was not desirable to try to bring hundreds or maybe thousands of auditors into the Federal system to go out and spend the weeks and months that it is taking with fairly large numbers of people to conduct these audits. And so it was concluded we would start with two. this was last spring we began the process to take on two look-back audits of companies, to see how they were conducted, to see what the costs were, to see what the recoveries were and then with the experience gained from that, we would know whether to carry on further.

At this point, our Inspector General is pressing forward with an additional number of audits. We think that the audit function should be conducted under the guidance of the Inspector General, but we do not think that we ought to have a force of, Federal employees who are permanent auditors.

We think it is a useful and an appropriate activity to be carried out by contract. It permits us to do the amount of auditing that is required. My personal experience with organizations is that if you acquire a group of people who are qualified to do a job and then you have done the job, it is exceedingly hard to remove those people or to change the scope of their work downward. Somehow we find additional things to do and not always all that productive.

Whereas if you are contracting, you are in a position to say we don't need that job done that way this year. We have a series of 25 or more audits that need to be conducted and then thereafter we have to have an annual, fairly quick and relatively simple audit to carry on.

Senator **Melcher**. On a lease where there are several operators or companies involved, let us use a Federal lease, for example, do you expect each operator representing a company to be responsible for that production figure and royalty figure?

Mr. **Hodel**. I believe that the requirement is that each is required to report to pay his royalty. Now, there is some question about the matter of the payor of record or an operator of record and we propose to move in that direction to the extent possible. I am advised again, as you have been, that there are all kinds of exceptions out there that we have to take into account, but it does seem appropriate to us that we need to have control over the assignment of leases so that we do not suddenly find ourselves being told we cannot collect from party A because he has assigned his interest to party B, but party B has not bothered to tell us or send us the necessary information.

We think we are entitled to be notified and we ought to accept that before we are bound by it and preferably on these leases we would have a single reporter, probably the operator, as to the volume of output.

Senator **Melcher**. Let us use an example. Blackfeet has a lease but Croft is the operator and this is a single lease. You look to Blackfeet, do you not, to pay the royalty?

Mr. **Hodel**. Yes, I believe that is correct. He is the lease holder.

Senator **Melcher**. Blackfeet is the lease holder.

Mr. **Hodel**. Blackfeet receives the proceeds of the sale. He pays the royalty.

Mr. **Pendley**. The operator sometimes has the interest and to the extent that the operator has an interest and on that interest he owes the royalty, then he pays that royalty. Sometimes operators are paid a fee, a flat fee and hold no interest.

Senator **Melcher**. If Blackfeet has the lease, and Croft is the operator who has an interest, are you expecting royalties to be paid on the Croft share directly by Croft?

Mr. **Hodel**. If Croft receives oil and sells it, yes.

Senator **Melcher**. If he does not, however.

Mr. **Hodel**. No.

Senator **Melcher**. If the lease is held, let us use the Federal lease example of 10,000 acres—is it?

Mr. **Hodel**. That is 2,560 acres in the lower 48.

Senator **Melcher**. We will use that figure. There is a lease for 2,560 acres issued to company A, in terms of farming out to companies B, C, and D portions of that lease. They all become operators; they all develop wells. Are you looking for companies A, B, C, and D to be responsible for the royalty on their production?

Mr. **Pendley**. Each one of the individuals that you have named, A through D, who hold an interest in that lease, and they all do under the statement you have made, they would be required to make a payment to us and we would——

Senator **Melcher**. Based on their oil production?

Mr. **Pendley**. That is correct. Now, with regard to the sale, the operator makes the report of production. We have approximately 650,000 paying interest, which are represented by about 1,435 separate individuals who pay out on those interests.

Senator **Melcher**. In this instance, I am saying that A, B, C, and D, we are talking about B, C, and D who got farmouts from A, but B, C, and D also end up being operators and producers themselves.

My question is do you expect A, B, C, and D based on their own production to make the payment? There is no common operator.

Mr. **Hodel**. Senator, I have been advised that that is exactly what happens. We look to the assignee for the payment or for the reports of operation. What we will seek to do to the extent we can is provide some control over that so that we don't find ourselves in a situation where apparently we have been in the past. This is hard for me to believe, but I am told there have been occasions in the past where assignments have been made and we accept the word of the assigning party that the assignment has been made and he is relieved of his reporting obligation on the part that has been assigned, but the person to whom the assignment was made did not get around to reporting that he was producing oil and selling oil.

That can't be tolerated. And I don't know anybody who is a landlord who would permit somebody to sublease without at least letting the landlord know, and particularly if the landlord was willing to accept the rental payments from the sublessee, I think he is entitled to be informed of it ahead of time.

We would like, in principle, to have a single operator of record and a single payor of record on each lease. It would be far simpler. Whether we can implement that in any way that is compatible with what is going on in the field, only time will tell. But we will try to work toward that.

Senator **Melcher**. I think that would be almost sure-fired to cause a lot of problems. If the person A who acquired all of the lease, is only going to produce part of the lease and indeed B, C, and D who acquired part of the lease from A are going to produce it on their own, they could easily produce oil from different pay zones and could produce it from even different fields as far as that goes.

And I don't know how A is going to know all of what B, C, and D have done. Is there any way of enforcing that?

Mr. HODEL. That is why, Senator, I had to say we are going to try to the extent it is possible or appropriate to do that. We simply may not be able or desire, in some cases, to require that kind of cross-reporting between companies. And if we are talking about different oil companies, different operators of oil wells, it may not be too difficult a problem to continue as we have.

Where we are talking about interest holders in a lease, it may well be quite simply to say——

Senator MELCHER. An interest holder in a lease that has no production.

Mr. HODEL. It could be an invester and who actually is never on the site and does not have any control of the records anyway and so it would be perfectly appropriate to look to the single interest holder.

Senator MELCHER. Mr. Pendley, when you said 695,000 paying interests, you are talking about ownership.

Mr. PENDLEY. That is 650,000.

Senator MELCHER. You are talking about ownership.

Mr. PENDLEY. Shares of interest in leases that have been issued.

Senator MELCHER. Yes, shares of ownership.

Mr. PENDLEY. There are only 1,435 who pay on those different 650,000 line items.

Mr. HODEL. There are only 1,435, or something of that magnitude, separate individuals or entities who are paying on those 650,000 line item accounts.

Senator MELCHER. First of all, I assume in your computer you are going to set up each well. Which company is obligated to report production and therefore report royalty?

Mr. PENDLEY. It used to be on each lease. We are going to a sublease level where we know the separate and individual interest in each lease.

Senator MELCHER. That is just now.

Mr. PENDLEY. Sir?

Senator MELCHER. To know who the subleasers are, that is just now. The subleaser may not be producing, correct?

Mr. HODEL. Then with that information, we also need to know what is produced from each of these wells.

Senator MELCHER. It will go back to the well.

Mr. HODEL. Yes, it ultimately will have to.

Senator MELCHER. So on each well you are going to know what the production is and what royalty is due from that well. Is that not correct?

Mr. HODEL. That is our objective, sir.

Senator MELCHER. So assigned to each well then will be a person of record, a person of ownership—I will put it the person of record to get away from this ownership—who is obligated to report the production and therefore start the proceduce of royalty obligations.

Mr. HODEL. I think that is stated very well, Senator.

Senator **Melcher**. So ownership of the well makes no difference, if the ownership of the well is divided between 50 people, 1 of whom is the owner of record and is therefore the person obligated to pay based on the reported production and based on the royalty from it.

Mr. **Hodel**. My understanding is that it would make this difference, depending on, sir, the circumstances. If the production from the well is distributed to more than one owner who is in turn a seller, then we have to know what that seller's price is in order to assess the royalty, because in fact they may be selling at different prices.

And as I indicated that may be one of the things we don't want to force people to do and, in fact, antitrust laws may not permit them to communicate their prices.

Senator **Melcher**. That may very well exist, that there could be producers on a single well who sell at different prices, I believe.

Mr. **Hodel**. Have different shares in the oil.

Senator **Melcher**. It is hard to believe that.

Senator **Hodel**. It depends on what they do with their oil.

Mr. **Melcher**. Then what about the doctor in Toledo who invested $10,000 in a well and therefore owes royalty because he owns 2 percent of whatever the production is.

Mr. **Hodel**. I don't know that that is a problem now, but I know that under our approach we would try to be sure that a person who is not directly involved in the operation and not directly involved in the sale ought not to have to be on our computer as a reporter of amounts made on the sale.

I think we would be looking to the person who was his agent for selling and presumably that would be one payor of record per well and maybe even a per sublease or whole lease.

Senator **Melcher**. Therefore, except on those wells where the production is sold by more than one individual and I suppose that exists, but since you brought it up, on those wells where the production is sold by one individual. that individual then is the one that is the person of record.

Mr. **Hodel**. I believe that is correct, yes, sir.

Senator **Melcher**. Is that correct, Mr. Pendley?

Mr. **Pendley**. To my understanding, if you could restate it, sir.

Senator **Melcher**. If on a well a producer, which well may be owned by 100 different people who have an interest in it, that producer is the one that is going to be on record and is going to be liable for paying the royalty.

Mr. **Pendley**. That is correct. He reports to us on his production.

Mr. **Hodel**. And sales.

Mr. **Pendley**. And to the extent that he sells.

Senator **Melcher**. Well, it seems to me the 650,000 names would bog down in the computer are not relevant to the computer.

Mr. **Hodel**. It may be relevant now, depending upon what has been acquiesced to in terms of with whom the responsibility lies. I would have to defer.

Mr. **Pendley**. We can be producing out of several zones on one well and each zone, as you know from your service on this committee, Senator, there are 21 varieties of natural gas out there and the difference in the zones would be 1,000 feet different which would result in a different price on that zone. We may require a different line item on that particular production from that different zone.

Senator **Melcher**. Does that not depend on how much you get for the gas?

Mr. **Pendley**. In order to assess the royalties, one of the problems the Linowes Commission uncovered was lack of good discretion or direction with regard to the private sector on the value of these products. We cannot assess a royalty unless we know, of course, the price of the product or the value of the product and the fair market value of that product.

So we have to have the ability to be discreet with regard to that particular differentiation.

Senator **Melcher**. If the terms of the lease are greater than 12½ percent royalty, and sold for $2.50 per 1,000, can you collect a royalty greater than 12 percent times 2½?

Mr. **Pendley**. Yes, sir.

Senator **Melcher**. Why?

Mr. **Pendley**. Because the value is different. We have a situation like that currently in the Gulf of Mexico where under a long-term contract the company was selling gas at 21 cents per thousand cubic feet. They were selling that gas for 21 cents per thousand cubic feet over the past 10 or 15 years. As you know, Senator, the value of gas is no longer at that price. And the Department of the Interior and the laws under which we operate, we believe that we have a requirement to collect at fair market values.

So we need to collect at more than 21 cents per thousand cubic feet and pursuant to a Secretarial decision last November, we are currently going after those people in the Gulf of Mexico and, of course, anywhere else, where production is being sold at less than fair market value. We are assessing our royalties on fair market value.

Senator **Melcher**. The producer has the contract for 21 cents per thousand cubic feet. Are you going to break it for him or are you going to tell him that he is going to pay on the basis of $3? This would be 12½ percent times $3. What happens in that case?

Mr. **Hodel**. What we have been asking, Senator, is what would be have if we were provided our gas in kind. We have a right to take either one-sixth of the price or one-sixth of the gas in kind and we are suggesting that we could do that and in turn find a market for that gas. That would permit us to sell it on the market at the market price.

That is not to say that that does not create some difficult situations for the people involved in this process and, of course, it goes back to long-term contracts that have been set at a fixed price.

Senator **Melcher**. What was the price when the contract was set? Was the contract approved by the Secretary?

Mr. **Hodel**. I believe it was accepted by the Secretary and had been acquiesced in over the years by virtue of taking in that payment based on the 21 cent scheduling price. The problem is to continue to accept that puts us in the position of agreeing to accept far less than the fair market value of gas. That puts us in the position of having an interest in whether that transaction between the producer of the gas and the person to whom he delivers it is an arm's length transaction. If there is not an arm's length transaction or if there is an escape clause in that contract that is not exercised, there is a great opportunity for a very significant difference in returns to them versus the returns to the Federal Government.

In order to protect the Federal responsibility here and the Federal revenues, we thought it may be essential to attempt to obtain the gas so we can sell it for our proper share.

Senator **Melcher**. Let us assume that the operator sold the royalty gas along with his share of the gas in good faith and that he was obligated to produce that amount of natural gas to satisfy that particular contract, does the Secretary now take his interest in kind? Does that not place that operator in a very precarious position?

Mr. **Hodel**. It places Gulf Oil or Exxon or somebody like that in a position of having to approach his other wells and see whether they should be used to make up the difference. I don't think it is appropriate for the Federal Government to be the insurer of those companies against inopportune contracts. If they had analyzed the law at the time they made the contracts, they really could have anticipated this might arise.

We don't think we can justify continuing in that process. There are several opportunities for the company to come in and seek relief from us because of some terrible inequity which might be caused by this. We did not think that we should assume that an inequity would be caused and not seek to recover the full amount to the Government.

Senator **Melcher**. There is a yardstick measurement. Let us keep it simple, because I don't know much about offshore gas. Let us take onshore gas, is that the type of contract and the type of royalty arrangement that is used in private industry in an adjoining area for Federal leases?

Mr. **Hodel**. I don't know, Senator, and I am not sure it would really be relevant. It would be relevant in principle, provided that the companies that were involved were abiding by some overriding statute. Our authority to contract or to acquiesce in a contract is limited by statute.

Senator **Melcher**. It is very relevant in this light. We can make, by Federal law, Federal leases and Indian leases unattractive because there is uncertainty on what the obligation would be for the developer. Certainly that uncertainty will be reflected in lack of enthusiasm for exploring on Federal and Indian lands and that is why I mentioned this yardstick to compare with.

We have never known the day, in my State, when we have had all of the oil explored, and every well drilled, that we would like to see drilled in hopes of taking either oil or gas. And I think that is probably true in other areas. We would like to see more exploration because if there is production it means revenue for the owners, first of all, of the oil or gas. And, second, it is revenue for the State and economic activity in the area. It is all very, very fruitful and very beneficial.

What is oil worth today? It is worth $30, I am told, in most fields and if the lease is let under terms where that price could, once contracted for from a given well, automatically escalate as the price of oil escalates, contrary to the contract, the prospective producer may not want to explore and attempt to develop oil or gas in that particular area.

It even gets more confusing when you get the gas, since gas quite often from a well which is contracted for a long period of time. In my State the best price you can get for it is $2 or $2.50 or $2.75, depending on where it is and the quantity.

If you were to apply a measurement that is unrealistic as to what that value should be, we may raise that even though you have got a contract for it. And that certainly should be reviewed on whether or not it would actually cut down on the exploration on Indian and Federal leases.

Mr. **Hodel**. As I am sure you are well aware, Senator, we too are very concerned, just as you stated, about both production and returns for production and feel strongly that there should be incentives. By the same token, we think that there are these occasional circumstances that get so far out of line that it is difficult to see that the Government should be the insurer when we really cannot look into the hearts of the people making that contract in the first instance to determine whether or not it was in fact arm's length.

Senator **Melcher**. The arm's length term is relevant here, but you are talking about the possibility of it being some sweetheart-type of contract.

Mr. **Hodel**. For instance, sale by the operator to a pipeline company where there is some kind of interlocking arrangement or other arrangements extraneous to this lease which would compensate for the lower price and would be an excellent opportunity, perhaps not even in any corrupt sense, but an excellent opportunity in which a longstanding working relationship would have the effect of cooling a price.

I don't think we can be in the position of just automatically accepting that price as the measure of our royalty and that is one of the things we have to look at in these look-back audits to make sure—to the extent we can, and again, records determine this. What is going on in the market is relevant, but we have to take a look at whether we are properly protecting the Federal revenue.

I think it is a responsibility that I know this committee wants us to have and I know other committees have certainly insisted that we carry it forward vigorously and we are attempting to do so.

Senator **Melcher**. Section 11 is about six lines long. I guess it is longer than that, about eight lines or nine. Is this only referring to oil and gas from the Outer Continental Shelf?

Mr. **Hodel**. What it is referring to, Senator, is regulated prices and it purports to provide that in valuing the mineral resource, we can value it based on the market, notwithstanding the price at which it is regulated.

Senator **Melcher**. Notwithstanding a prior contract.

Mr. **Hodel**. This does not, I believe, apply to prior contracts. I would have to believe, Senator, that, unless at the time the contract was entered into the law was clear that we had the authority or the obligation to do something we could not interfere with that contract under the Constitution and that therefore an agreement on our part or an interpretation of the contract, provided it was not contrary to a statute, would be binding on us and would not permit us to come back and rearrange prices later.

Our obligation to collect for the Federal Government a royalty based upon the fair market valuation is something that runs through all of our leasing activities, as you know. Fair market valuation is a difficult and an important concept. Royalties should be charged based on fair market value and gross proceeds received by the lessee, not on some regulated price which is established by a regulator somewhere.

Senator **Melcher**. Section 12 proposes with it, I believe.

Mr. **Hodel**. Section 12 was included to provide some technical assistance and relief to a very special situation which arose, of which you may be familiar, Senator, when we billed refiners based upon new oil price.

A technicality required that that determination, whether it was new or old oil, be made within 60 days under the Department of Energy regulations. The Department of the Interior failed to make that determination within 60 days but proceeded to bill what everybody knew to be new oil as new oil at new oil prices.

Now, we are in three or four lawsuits being sued by refiners to recover back what they consider as the excess amounts paid. This concerns oil that was acquired by the refiners and sold as new oil at new oil prices and they are now, based on this technicality of our not having made the certification to DOE within the 60-day period, wanting us to refund the approximately $1.1 billion that they claim had been overcharged.

We believe that section 12 is appropriate in order to avoid what would surely be a windfall. We would remain liable to suit or make administrative adjustments where there was a clear inequity caused to some refiner who had in fact acquired old oil and sold it at old oil prices and for some reason found himself being billed based on new oil.

Senator **Melcher**. I wonder if I have the right impression that under your proposed royalty accounting system the company would make the payment of royalty based on the forms they send in and they would not wait to be billed; they would just automatically pay.

Mr. **Pendley**. That is right, automatic payment.

Senator **Melcher**. So they would not send in their forms and then wait for management to write back and tell them how much they owed.

Mr. **Pendley**. That is correct. It is self-initiated. They don't wait for a billing from us. They pay on the basis of their production.

Senator **Melcher**. I would appreciate from the Department some sort of evaluation on how independent oil operators view this exploitation for oil and gas onshore. How would they react to the type of lease which might require them to pay a greater royalty payment, either to the Federal Government or to Indian tribes, if the Secretary changes the value of the oil or gas to actually exceed what they got for the oil.

In other words if the royalty is 12½ percent and the oil is sold at $30, the Secretary may determine the fair market value at $34, although they don't sell it at 34, they have to pay a royalty of 12½ percent times $34. How would that affect their disposition toward, drilling on Indian or Federal lands.

Mr. **Hodel**. Senator, I think that precise situation applies now and is precisely what is involved in section 12 and the litigation.

Senator **Melcher**. Section 12 deals with the Emergency Petroleum Allocation Act of 1972 and other regulations. I am not talking about that.

Mr. **Hodel**. Section 11?

Senator **Melcher**. Yes, I am talking about section 11. It seems to me that section 11 gives the Secretary the authority to say whether or not the royalties are being paid on the fair market value of the oil. Therefore, you are going to have to pay on the basis of what the Secretary determines as the fair market value.

Mr. **Hodel**. I am intrigued by the question, Senator, because I think that situation exists now and that one of the arguments and disputes that occurs when we go back on these look-back audits is the question of what constitutes fair market value for purposes of assessing the royalty. I think we are in that box today.

If that is not correct——

Mr. **Pendley**. That is correct.

Mr. **Hodel**. That is correct, I am assured. The specific language of section 11, of course, relates strictly to the matter of regulatory pricing on the resource. This would be oil or gas and would permit us to charge the royalty and the obvious inequity is that a State regulator who would have control in some cases or a Federal regulator having control could control the price at one level and we would do as we are now attempting to do in the Gulf transaction and take our royalty at a percentage of the fair market value rather than the regulated price.

Senator **Melcher**. Well, if you read (A) it says:

> The Secretary shall include gross proceeds received from the sale of production of any mineral resource from any lease on the Outer Continental Shelf, Federal or Indian lands in valuing production for royalty purposes.

I would assume a posted price in the oil field for various grades of oil is what the oil is worth and that the producer is selling it for the posted price or better.

Mr. **Good**. Senator, if I might try to clarify what our intent was in drafting this provision. When you have a regulated gas price now and perhaps it is regulated, let us take an arbitrary figure of $1 and the Department of Energy grants an exception and allows $2 to be charged, this provision simply would confirm our existing practice of charging the royalty on the $2 figure and not the $1 figure, which many companies have argued, they should only be charged. I think we can look at it on the other side of the coin.

Senator **Melcher**. I see. I am looking at one aspect and you are looking at the other side. But I do believe that first phrase stands alone that:

> The Secretary shall include gross proceeds received from the sale of production of any mineral resource from any lease on the Outer Continental Shelf, Federal or Indian lands in valuing production for royalty purposes.

I believe that stands alone, particularly from the aspect I am looking at—if the Secretary were to set a price, which might be contrary to the price actually received by the producer. I mean it might be lower or higher than was actually obtained.

Mr. **Good**. I think we drafted section B to attempt to get at that which I understand to be your concern and that is the Secretary's ability to value it at greater than the regulated price or indeed the contract price. In other words, section A would deal with the situation which I discussed where a producer was granted an exemption from a price restriction and therefore was allowed to sell it at a higher level.

Section A would confirm our practice that we will charge the royalty at the higher level. And section B does not limit the Secretary's ability to charge and receive fair market value to that which is either regulated price or contract price.

Senator **MELCHER**. Well, section B, if you look at this in depth, "the Secretary shall not be bound by by a prior valuation." And if the prior valuation was $30 and that is what the oil is being sold for and the Secretary says, I think it ought to be for $34, yet the contract is such that it only has to be sold at $30 or the operator will lose $4 on 12 and one-half percent.

Mr. **GOOD**. I think it would take a legislative enactment to change the Secretary's duties, the statutory directives, to charge fair market value, regardless of what the operator or the lessee had contracted to sell it for. As a matter of fact the lessee could be on both sides of that. They could have a very beneficial contract or one that was not so beneficial.

Senator **MELCHER**. First of all, is all you want fair market value?

Mr. **GOOD**. That is correct.

Senator **MELCHER**. Then let us take natural gas. If it is gas dedicated and contracted under the terms of a contract for a long period of time, and the price eventually, say in 1988, is not fair market value, as it was in the 1982 dedication, what if the producer cannot get out of that contract?

Mr. **GOOD**. Once again, we do not believe the Government should be the insurer of that lessee's or operator's contract and they must take into account that our regulations for some period of time have made it very clear that we look at fair market value at the time of production, not at the time of the individual contract and that may work some hardship in some cases. And that is another thing the lessee should take into account when entering into a long-term contract.

Senator **MELCHER**. Have utility companies commented on that?

Mr. **GOOD**. On this particular provision?

Senator **MELCHER**. Yes. That is what you are saying.

Mr. **GOOD**. I know there is indeed concern on the part of a number of companies that we not be able to charge fair market value but rather be restricted in what we charge to the contract price that they entered into.

Unfortunately that is not our statutory directive, fortunately or unfortunately, that is not our statutory directive.

Senator **MELCHER**. It seems to me I did not know the Secretary had been altering the prices on gas wells as gas went up.

Mr. **HODEL**. He has not.

Senator **MELCHER**. So we are talking really about a very significant change.

Mr. **HODEL**. No, sir, we are talking about a specific situation which was drawn to our attention now nearly a year ago by our Inspector General, which was that by virtue of not being paid on the fair market value and by accepting a 21 cent valuation, which was the contract price, we were losing $40 or $50 or $60 million a year in royalty payments and the Inspector General's opinion was that we were not being very responsive to our obligation and he said that in whatever terms were necessary to get our attention and he did.

I do think we have a clear right to ask for the delivery of our gas and that we can then in turn sell that gas. We have not resolved this matter. It is not easily resolved, as you may imagine, because you have got production problems and delivery problems.

But if we cannot do that, we are placed in the position where by contraot an operator can commit the price of that gas for the next 20 years or oil for the next 20 years and the Federal Government assumes the risk. Unless we have some magical way of determining good faith on his part, we assume the risk that the price will not rise or that it was a good faith transaction. There is a very good way to make sure it is a good faith transaction and that the party is properly protected and that is to have language in the statute that makes it plain we are obliged to collect based on the fair market value.

It would be very helpful to us to have that and avoid the arguments and avoid letting people fall into a pit where they think somehow they can bind us for 20 years and later a court comes along and says that there is no way you can override the statute which says that the Secretary must obtain fair market value.

Senator **MELCHER**. I know all sorts of private owners of natural gas that wish to change the terms of their contracts. I suppose they get 40 or 50 cents and, of course, now, depending on where it is on the delivery system, it could be worth up to $3.75 per 1,000. But the contract has been entered into and so that is all of the royalty they can get, but they understand that because the contract was set.

What you are telling me is on Federal gas that the taking in kind was always an option and still remains an option, and although it has not been exercised, it is an option under the statute.

Mr. **HODEL**. And in some cases, I believe we do take in kind oil for delivery to small independent refiners. In fact, I think that is what led to the section 12 problem of oil. So we have had that right and we have exercised it and, in all practicality, I think that the vast proportion of people, when I say people we know we are talking about generally fairly large and sophisticated corporations, are well aware of the fact that there is that potential.

It may not have been thought so 20 years ago when a 21 cent price looked like a very good deal. I suspect at that point it was a few cents more than the going price and it looked like a good deal.

Senator **MELCHER**. Just so I understand this, the in kind provision also applies to Federal oil.

Mr. **HODEL**. I believe that is correct, sir.

Senator **MELCHER**. It has always been part of the law.

Mr. **HODEL**. Yes.

Senator **MELCHER**. I want to thank you all very much, including Mr. Wyatt and Mr. Harrison and Mr. Campbell, for your testimony and help in explaining the intent of this bill.

Mr. **HODEL**. Senator, may I express my appreciation and the appreciation on the part of the people who accompanied me here today. I think that the level of concern which you have demonstrated in this bill is gratifying to us. We appreciate it because this is a significant step, but we think it is a very important one and we are very happy to go through what our thinking is and why we believe it is important.

Thank you so much.

Senator **Melcher**. Thank you very much. And the committee is adjourned.

[Whereupon, at 1:30 p.m., the committee adjourned.]

APPENDIX

Responses and Additional Material Submitted for the Record

United States Department of the Interior
OFFICE OF THE SECRETARY
WASHINGTON, D.C. 20240

MAY 19 1982

Honorable James A. McClure
Chairman, Committee on Energy and
Natural Resources
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

I am happy to provide answers to questions raised during the May 17 hearing on S. 2305, the Federal Royalty Management Act of 1982.

I want to thank you for your assistance on the Administration's proposal to better manage and enforce the royalty collection system.

Sincerely,

Donald Paul Hodel

UNDER SECRETARY

Enclosure

Q.1. What is the daily oil and gas production in the Bakersfield District and how many producing leases are there in that district?

A.1.

	Daily 1981 Oil	Production Gas
California	56,290 BOPD	17,243 mcf/day
Nevada	1,374 BOPD	—
Total	57,664 BOPD	17,243 mcf/day

There are a total of 362 producing leases in the Bakersfield District.

Q.2 How many active drilling rigs are there in the United States? Of those how many are operating on Federal and Indian lands and on the OCS?

A.2. The total rig count as of 3/29/82 is 3,639 rigs. The breakdown is as follows:

OFFSHORE	California OCS	Louisiana OCS	Texas OCS	TOTAL
Federal	24	135	89	248
State	—	66	13	79
TOTAL	24	201	102	327

ONSHORE	Number
Federal	1,266
Indian	165
State and Private	1,881
TOTAL	3,312

Q.3. What is the status of recruitment for Onshore Petroleum Engineering Technicians?

A.3.

SUPPORT ACTIVITIES FOR MMS
AS OF MAY 14, 1982

PERSONNEL

1. Status of Recruitment for Onshore Petroleum Engineering Technicians

	Total On Board	Commitments Pending	Vacancies Remaining	Total
Eastern Region	3	0	0	3
Western Region				
- California	7	0	1	8
- Alaska	1	1	1	3
Central Region				
- North Central	27	5***	4	36
- Central	13	1***	2	16
- South Central	30	7***	11	48
TOTALS:	81	14	19 (2 less than last report)	114

STATUS OF VACANCIES REMAINING

Western Region

- California:	1 - vacancy announcement closed April 16, 1982, and 2 candidates referred, no selection yet.
- Alaska:	1 - merit promotion announcement for supervisory position closed March 15, 1982, and 1 candidate referred for interview and selected, but no acceptance date established yet.

Central Region

- North Central:	2 - supervisory positions, open-continuous announcement issued, 2 applicants - referrals issued March 25 and April 1, 1982, selections not finalized.
	1 - job offer declined - new referrals to be made.
	1 - candidate with job offer, awaiting a response.
- Central:	1 - supervisory position, 1 candidate referred for interview, no selection made yet.
	1 - position pending paperwork.
- South Central:	11 - vacancies, including: 10 with job offer letters just sent, awaiting acceptance by selectees; 1 position awaiting OPM certificate.

***UPB - Includes University of Pittsburgh at Bradford, Pennsylvania, applicants from their 2-year PET program. Most will not be available until the end of May 1982.

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

ACCOUNTING AND FINANCIAL
MANAGEMENT DIVISION

1982 MAY 27 PM 12:49

MAY 25 1982

The Honorable Malcolm Wallop
United States Senate

Dear Senator Wallop:

In our May 3, 1982, testimony before the Committee, we were asked to provide certain information for the record. Our responses are enclosed.

We appreciate the opportunity to appear before the Committee to discuss S. 2305--a bill to improve the accounting and control for revenues due from Federal and Indian lands. We hope our testimony and enclosed responses will be beneficial to the Committee in considering the proposed legislation.

Sincerely yours,

W. D. Campbell
Acting Director

Enclosures - 3

GAO RESPONSES TO THE COMMITTEE ON ENERGY AND NATURE RESOURCES

In our May 3, 1982, testimony, we were asked to provide certain information for the record. Our responses are discussed below.

Question 1: GAO recommended that Interior explore the possibility of sharing its auditing and inspection responsibility with the States. Has there ever been any discussion of the possibility of the States collecting the royalties due on Federal and Indian leases and reimbursing the Government and Indian tribes?

Response:

We believe that royalty accounting and collecting may best be performed by the Federal Government because of the diversity or lack of State systems and the need for consistency on Federal leases. The Federal Government must retain its oversight responsibility in those instances where State and Indian tribes take over certain royalty management functions through cooperative agreements with the Federal Government.

In testimony before the Commission on Fiscal Accountability, various States and Indian tribes expressed a desire to be more active in royalty management--both in site security and royalty collection. Recently, Interior entered into cooperative audit agreements with several States and plans agreements with others. The Commission recommended that this effort be expanded to include Indian tribes and the inspection function.

To alleviate reliance on unverified data, we have long called for the Department to determine what secondary sources of data are available among Government and State agencies and in the oil and gas industry. We have recommended that Interior explore the possibility of sharing its auditing and inspection responsibility, and of exchanging information on production and sales with the States.

Question 2: Your testimony mentioned there was no systematic way that Interior has of knowing when new production begins on a lease. Is this due to a problem in manpower and management within Interior, or to an omission in the law or regulations relative to lessee reporting requirements? Don't the regulations require lease operators to report when production starts on a lease, and aren't all royalties paid on all oil or gas recovered, even though Interior may get notice of such production start two or three weeks after the fact?

Response:

Recent hearings, before various congressional committees and the Commission on Fiscal Accountability, pointed out that the Department's inadequate lease inspections and monitoring have resulted in thefts and lease violations on Federal and Indian lands. The agency provided inadequate coverage--only about 60 inspectors to review the activities at about 44,000 producing wells--a ratio of 1 inspector for every 698 wells. The Department should devote additional resources to the inspection effort and explore the possibility of also sharing this function with the States. While it is recognized that additional resources are needed to conduct meaningful inspections, the requirement of immediate notice would greatly enhance existing inspection and enforcement efforts.

Existing legislation does not require operators to immediately notify the Secretary of Interior when a new well begins production. However, existing regulations, incorporated by reference in the leases, require that notice of intention to drill be filed, but do not explicitly require that the notice include the anticipated date of initial production (30 C.F.R. 221.58(a)). There is also an administrative requirement that monthly production reports be submitted, "...beginning with the month in which drilling operations are initiated...on or before the 6th day of the succeeding month..." (30 C.F.R. 221.60). As a practical matter, this allows up to 36 days to pass before the lease operator is required to notify the Department that production has begun.

Under existing law all production should be reported, but the lack of immediate notice severely impacts the inspection and enforcement efforts. Field inspectors need to have prompt reports on when new wells start to produce. Under the present system, the monthly production reports reach the field inspector several weeks after the production covered in the reports took place. We, therefore, recommend that operators be required to report new production immediately, which could be accomplished either by statute or by regulation. However, the civil penalties provided in S. 2305 would not be available, in the case of onshore wells, unless this provision of the proposed legislation is enacted.

Question 3: Your testimony notes that S. 2305's requirement that the Secretary be notified of lease assignments and an existing problem which you characterized, in part, as the receipt of royalty checks which don't identify the lease involved. If I am correct, the present regulations pertaining to oil, gas and other mineral leases presently require notice of all assignments to be made within a certain time period. Could this problem be resolved by a revised rulemaking, or is there some other problem in the royalty collection system which requires new Federal legislation as a cure?

Response:

Existing regulations require that Interior be notified of all assignments. The Mineral Lands Leasing Act, as amended provides that:

> "No lease issued under the authority of this chapter shall be assigned or sublet except with the consent of the Secretary." (30 U.S.C. 187)

Additionally, pursuant to authority contained in the Outer Continental Shelf Lands Act (43 U.S.C 1334(a)(3)), regulations regarding offshore wells require that:

> "* * * all instruments of transfer of a lease or of an interest therein, including assignments of working interests, operating agreements, and subleases, must be filed for approval within 90 days from the date of final execution * * *."
> (43 C.F.R. 3106.13)

Ideally, the names of all assignees or sublessees should be recorded in the Department's accounting system, and the Secretary clearly has the authority to promulgate rules to this effect. However, as pointed out in our testimony, Interior has from time to time received royalty checks for which it is unable to identify the leases involved. It is apparent, therefore, that the applicable requirements have not always been adhered to.

The existing sanctions, such as lease cancellation and compensatory damages, for not notifying the Secretary of assignments may be impractical as a means of inducing compliance. We recognize that the Secretary already has the authority to impose civil money penalties for violation of regulations related to offshore leases. Under S. 2305, the failure to comply with the act's notification requirement would subject violators to civil penalties and possible criminal sanctions for willful noncompliance. In our opinion, this is a far more effective sanction to insure compliance.

Question 4: GAO has been looking into the new accounting system that Interior is presently in the process of installing to verify royalty information. Please summarize the results of these recent studies or investigations on the royalty accounting system.

Response:

To its credit, the Department of Interior is designing a new royalty accounting system and has placed emphasis on the need for an effective royalty management program.

Interior refers to the new royalty accounting system as a modified Internal Revenue Service system, because all data submitted will be assumed to be correct subject to extensive computer analysis, screening, and audit. The system is to be implemented in three phases--(1) the royalty accounting phase; (2) the production phase which will permit the matching of production and sales data; and (3) the enhanced management phase which will center on developing quality review and management data. Current estimates are that the first phase will be fully implemented by fiscal 1983 and the second phase by fiscal 1984.

American Management Systems, Inc. was awarded a contract on September 17, 1981, for $4.3 million for the design and implementation of the accounting phase. In addition, the contractor will be responsible for preparing a preliminary design of the production phase. A detailed systems design of the production phase, which is an option of the contract, requires further negotiation between the Interior Department and the contractor.

Many of the longstanding accounting problems have been considered in the preliminary design of the accounting phase. However, since the design effort is still underway and the accounting phase will not be operational until January 1983, it is too early to tell whether the effort will be successful. Also, to be fully effective the phase must ultimately interface with the other phases of the system, as well as inspections and audits.

In regard to the production phase, we have expressed our concern to the Department of Interior about its development. This phase is extremely important, because of the need to alleviate the reliance on information reported by the oil and gas companies. The matching of production data and sales data would enable the Department to identify situations where oil and gas produced was not properly accounted for. It would also provide the means to monitor lease activities and identify irregularities in reported production and/or sales, and can be used as an indication of the reasonableness of the reported data.

The Department has an overall concept for the production phase and is developing plans as to how this phase is to operate and how it will interface with other phases of the system. For example, the agency must determine how the production phase will make use of such information as runtickets and meter readings. In addition, it must define how the accuracy of the reported product value will be determined.

The contractor, in a letter accompanying its offer, stated that the production phase is critical to the improved royalty accounting system and is, itself, so complex in concept and so vaguely defined, that it requires total commitment by both the contractor and the Department of the Interior. In December 10, 1981, testimony before the Commission on Fiscal Accountability, the contractor acknowledged that the development of the production phase is still hampered by many unknowns.

The most important step in developing a system is determining the requirements, and in our view, it is critical that the Interior Department, as the user, clearly define its needs. Not only must problems be identified and defined, agency officials must also agree on the scope of the system. Planning is all important in developing and designing an accounting system; a system that is not well planned is not likely to be effective. In its development of the new royalty accounting system, the Department must address the problems in the current system as well as gain control over the data reported by the oil and gas companies.

Historically, Federal agencies have experienced problems in designing and implementing viable financial management systems because of insufficient management attention to the effort. In order that its new system does not succumb to the problems encountered by other agencies, in designing and implementing the new system, Interior must assure a sustained high priority effort--one with long term top management involvement. The problems confronting the Department in this area cannot be solved immediately. In today's environment of budget reductions and constraints, it is incumbent upon top agency management to ensure that the improved royalty management program receives the attention and resources it needs. Without the necessary people and money, the system for collecting royalties will not likely be improved.

In this regard, we have called on Interior to update its cost estimate for the royalty management program. The current cost estimate of $208 million to design and operate the new system over the next 10 years does not take into account significant changes in contractor services, computer equipment, and staffing, nor has the total cost of the planned production phase been considered. In addition, the cost increases in the auditing and lease inspection functions have not been estimated.

The Government cannot afford slippage in time or misdirection of resources in this effort. It is critical that the needs and costs be determined as early as possible. We believe that congressional and executive branch oversight are needed to assure that adequate resources are available and that the development of the improved royalty accounting system stays on target.

We have enclosed copies of our October 29, 1981, report titled "Oil and Gas Royalty Collections--Longstanding Problems Costing Millions," (AFMD-82-6) and our April 27, 1982, report titled "Oil and Gas Royalty Accounting--Improvements Have Been Initiated But Continued Emphasis Is Needed To Ensure Success" (AFMD-82-55). These reports discuss our concerns about the developments of the royalty accounting system and the Department's efforts to address these concerns.

REPORT BY THE

Comptroller General

OF THE UNITED STATES

RESTRICTED — Not to be released outside the General Account[illegible] except on the basis of specific approval [illegible] Congressional Relations.

Oil And Gas Royalty Accounting--Improvements Have Been Initiated But Continued Emphasis Is Needed To Ensure Success

The Department of the Interior's royalty accounting system has been plagued with many serious financial management problems for over 20 years. The Department is currently making a serious effort to correct these problems by designing and implementing a new royalty accounting system.

The ongoing efforts--which include the design of the system as well as the implementation of the recommendations in GAO's October 1981 report and the recommendations of the Commission on Fiscal Accountability of the Nation's Energy Resources--provide the foundation for resolving the longstanding problems.

Congressional and executive branch oversight are needed to assure that the current impetus continues and that the development of the improved royalty accounting system stays on target.

UNITED STATES GENERAL ACCOUNTING OFFICE

AFMD-82-56
APRIL 27, 1982

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-199739

The Honorable Edward Markey
Chairman, Subcommittee on Oversight
and Investigations
House Committee on Interior and
Insular Affairs

Dear Mr. Chairman:

Your July 13, 1981, letter requested that we evaluate the development of the new royalty accounting system and determine the extent to which it will improve the collection of royalties due from Federal and Indian lands. This report discusses our concerns about the development of the new system as well as covers our review of the Interior Department's efforts to solve its longstanding financial management problems.

On October 6, 1981, we testified before your Subcommittee on the status of our review at that time. We issued a followup report on October 29, 1981, showing that the royalty accounting problems we have been reporting on since 1959 not only persist but have become worse. 1/ And on January 21, 1982, the Commission on Fiscal Accountability of the Nation's Energy Resources--an independent Commission established by the Secretary of the Interior--issued a comprehensive report on the royalty accounting problems, including 60 recommendations for corrective action.

We worked closely with the Commission and testified before it on three occasions. The Commission recommended the strengthening of accounting for and control over royalties. Its proposals are in line with our prior recommendations.

On March 23, 1982, we testified before the Subcommittee on Interior, House Committee on Appropriations, in support of the Commission's report. Also testifying were the Secretary of Interior and the Chairman of the Commission. The Secretary pledged to implement the Commission's recommendations and indicated that correcting the longstanding financial management problems that have continually plagued royalty accounting would receive high priority.

It is of the utmost importance that the problems identified be corrected as soon as possible. Royalty collections have increased rapidly in recent years, primarily because of substantial increases in oil and gas prices. With oil prices decontrolled on January 28, 1981, this trend can be expected to continue. Based

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1/"Oil and Gas Royalty Collections--Longstanding Problems Costing Millions," (AFMD-82-6).

on January 1982 estimates by the Interior Department, annual royalties are expected to be at least $5 billion in fiscal 1982 and could grow to about $15 billion by fiscal 1990.

Historically, a high priority has not been placed on collecting oil and gas royalties, and major problems have gone virtually unchecked for over 20 years. As a result, large sums may be going uncollected each year. Also, significant amounts of royalty income have not been collected when due, thus increasing the Government's interest costs.

The current royalty accounting system is in disarray. Oil and gas companies are essentially on an honor system to report accurately and pay royalties when due, and the Department has been unable to account for the information reported to it, much less to verify this information.

To its credit, Interior is attempting to correct these long-standing problems and has placed emphasis on the need for an effective royalty management program--emphasis that is long overdue. The Department is designing a new royalty accounting system and has awarded a contract for the design and implementation of the accounting phase. However, as we testified on October 6, since the design effort is still underway and the accounting phase will not be operational until January 1983, it is too early to tell whether the effort will be successful.

In our testimony, we also expressed concern that the Department had not adequately considered

--acquiring data on the number of leases and wells for which it is responsible,

--verifying the royalty computation,

--developing a comprehensive plan for audits and inspections, and

--planning of the production phase of the new system which will permit production and sales data to be matched.

Corrective action has since been taken or promised in each of these areas. Ongoing efforts to redesign the system, coupled with the implementation of the recommendations in our October 1981 report and in the January 1982 report of the Commission on Fiscal Accountability, provide the foundation for resolving the serious long-standing problems.

The problems confronting the Department of the Interior in this area, however, cannot be solved immediately. In today's environment of budget reductions and constraints, it is incumbent upon top agency management to ensure that the improved royalty management program receives the attention and resources it needs. Without the necessary people and money, the system for collecting royalties will not likely be improved.

In this regard, Interior needs to update its cost estimate for the royalty management program. The current cost estimate of $208 million to design and operate the new system over the next 10 years does not take into account significant changes in contractor services, computer equipment, and staffing, nor has the total cost of the planned production phase been considered. In addition, the cost increases in the auditing and lease inspection functions have not been estimated.

. The Government cannot afford slippage in time or misdirection of resources in this effort. It is critical that the needs and costs be determined as early as possible. We believe that congressional and executive branch oversight are needed to assure that adequate resources are available and that the development of the improved royalty accounting system stays on target.

We therefore recommend that the Secretary of the Interior, no later than September 30, 1982, develop cost estimates, broken out by fiscal year and function, for the new royalty management program. This information, which should be furnished to cognizant congressional committees, should include milestones for implementation of specific system improvements and, as a minimum, should detail the cost of personnel, contractor services, and computer equipment for the

--design and implementation of the accounting, production, and enhanced management phases;

--performance of audits;

--lease inspection function; and

--reconciliation of existing lease account records.

Appendix I details our findings and recommendations on the development of the improved royalty accounting system. Appendix II gives the objectives, scope, and methodology of our review. Your July 13, 1981, letter is enclosed as appendix III.

As requested by your office, we did not obtain official agency comments. Unless you publicly announce its contents earlier, we plan no further distribution of this report until 7 days from its date. At that time, we will send the report to interested parties and make copies available to others upon request.

Sincerely yours,

Milton J. Socolar

Acting Comptroller General
of the United States

FINDINGS AND RECOMMENDATIONS ON THE DEPARTMENT OF THE INTERIOR'S ROYALTY ACCOUNTING SYSTEM

Historically, management has not placed a high priority on the collection of oil and gas royalties. Consequently, serious deficiencies in the collection system that were identified over 20 years ago persist today. As a result, large sums may be going uncollected each year. Also, significant amounts of royalty income have not been collected when due, thus increasing the Government's interest costs.

The Department of the Interior is finally making a serious effort to correct the longstanding financial management problems that have plagued royalty accounting. To be successful, these efforts must be given a high priority at all levels of Government.

ROYALTY ACCOUNTING SYSTEM NEEDS IMPROVEMENT

Since 1959, numerous GAO and Interior Department audit reports have pointed out the need for the Department to improve its royalty accounting system. In our April 1979 report, "Oil and Gas Royalty Collections--Serious Financial Management Problems Need Congressional Attention" (FGMSD-79-24, Apr. 13, 1979), we recommended both short and long range solutions to the problems facing the Department. Our October 1981 followup report shows that the problems previously reported not only persist but have become worse ("Oil and Gas Royalty Collections--Longstanding Problems Costing Millions," AFMD-82-6, Oct. 29, 1981).

As our followup report points out, Interior still relies almost entirely on production and sales data reported by the oil and gas companies, making little effort to verify the accuracy of the data. In short, the oil and gas companies are essentially on an honor system to report royalties accurately and pay them in full when due. The Department must begin to determine what other sources of data are available among Government and State agencies and in the oil and gas industry that can be used to verify the data now received.

Compounding this situation is the breakdown of the automated royalty accounting system. Lease account records continue to be inaccurate and unreliable and thus cannot be used to determine if royalties are properly computed and paid. For instance, our analysis of 275 randomly selected lease accounts disclosed errors totaling over $1.1 million, which clearly indicates the seriousness of the problem the Department has faced in maintaining accurate lease account records. We have been reporting on the inaccuracy of lease account records since 1959.

Another longstanding problem centers on Interior's inability to ensure the timely collection of royalties. As far back as 1959, we reported that all royalty payments were not received when due.

Our recent analysis showed that annual royalties of about $390 million were paid late, costing the Government about $1.6 million in interest. In our April 1979 report, we called for interest to be charged on late payments, and although agreeing to do so, the Department has been slow in acting. As discussed in our October 1981 followup report, interest was not charged on late payments applicable to offshore leases until September 1980; instructions for charging interest on late payments were not provided to field offices handling onshore oil and gas leases until June 1981; and no interest was collected for onshore late royalty payments until July 20, 1981. Charging of interest should be used as an incentive to encourage oil and gas companies to keep their payments current.

In addition to establishing a reliable royalty accounting system, Interior must increase its auditing and monitoring of lease accounts, functions which continue to be ineffective in controlling royalty payments. In fiscal 1980, only 5 percent of the lease accounts were audited nationwide, even though those audits proved beneficial by leading to additional collections of over $7.7 million. In our October 1981 testimony, we called on the Department to explore the possibility of sharing its auditing and inspection responsibilty and of exchanging information on production and sales with the States. Audits often uncover information that has an effect on other leases, including State and private leases, and such information could be shared between Federal and State auditors.

THE DEPARTMENT OF THE INTERIOR IS TRYING TO CORRECT ITS FINANCIAL MANAGEMENT PROBLEMS

The Interior Department, recognizing that its existing accounting system was inadequate, formed a task force to determine the deficiencies in the system and to recommend a course of action for correcting them. The task force recommended that a new royalty accounting system be designed and implemented. The new system, which will not be fully operational for several years, is to be implemented in three phases: (1) the royalty accounting phase, (2) the production phase, which will permit the matching of production and sales data, and (3) the enhanced management phase, which will center on developing quality review and management data. Current estimates are that the first phase will be fully implemented by fiscal 1983 and the second phase by fiscal 1984.

As pointed out in our October 1981 testimony, many of the longstanding accounting problems have been considered in the preliminary design of the accounting phase. However, since the design and implementation of the accounting phase is not yet complete and the phase will not be operational until January 1983, we are unable to tell whether the problems will be solved.

In addition, during testimony we expressed concern that in developing the improved royalty accounting system, the Department appeared to have not adequately considered

- --acquiring data on the number of leases and wells for which it is responsible,
- --verifying the royalty computation,
- --developing a comprehensive plan for audits and inspections, and
- --planning of the production phase of the new system which will permit production and sales data to be matched.

Acquiring data on leases and wells

Before Interior can effectively control and monitor royalty collections, its system must have accurate, reliable, and timely information on the number of leases and wells for which it is responsible. Without such information, the agency has no assurance that all individuals who are responsible for paying royalties are in fact making payments. The Department, however, decided to prepare its lease master file--a list of leases and payors--from data in the existing system, data the agency is not certain is complete and accurate. If payors are not listed in the current system, they cannot be carried over to the new system data base. As we testified, to obtain information related to the total number of leases it is responsible for, Interior should consult with the Bureaus of Land Management and Indian Affairs. Unless it can maintain exact accountability for leases and payors, the agency will be hampered in its efforts to manage and monitor royalty collection.

In November 20, 1981, testimony before the Commission on Fiscal Accountability of the Nation's Energy Resources, Interior agreed that all leases might not be recorded in the new royalty accounting system. The agency acknowledged that in developing the data base for the new system, it occasionally received reports and payments for a partial lease interest. Interior said then it would consult with the Bureaus of Land Management and Indian Affairs as we had called for and agreed to try to expedite this effort.

The Department has since completed its review of leases on file with the Bureau of Land Management, but it does not plan to coordinate with the Bureau of Indian Affairs until late 1982. An agency official said that since the Bureau of Indian Affairs does not maintain a separate listing of producing leases, a lease-by-lease review would be required, a task for which the staff resources are not currently available.

Verifying the royalty computation

Besides determining who should pay royalties, Interior must also determine how much is due. In the current system, the amount of royalties due is computed and compared with the amount paid by the oil and gas companies. If properly used, this control can provide a means of identifying troublesome lease accounts and companies. As we testified on October 6, our review of the technical specifications for the new system and discussions with Department personnel indicated that the new royalty accounting system would no longer recompute the royalties owed. In its November 20 testimony, the Department subsequently testified that this control feature would be part of the new royalty accounting system, which satisfies our concern.

Developing comprehensive plans for audits and inspections

Another area of concern expressed in our October 1981 testimony was the lack of a comprehensive, systematic plan for (1) monitoring, reconciling, and auditing lease account records, (2) inspecting leases, and (3) verifying production and sales data. At that time, the Department had not developed such a plan for accomplishing these tasks, although the importance of inspections and audits as integral parts of royalty management had been recognized and although additional auditors, accounting technicians, and inspectors had been hired.

We were subsequently advised that an audit plan was finalized on February 3, 1982. Although we have not had an opportunity to review the plan, it should (1) identify the additional resources needed to accomplish the tasks, (2) provide for periodic reviews of lease accounts, and (3) continue coordination with the States to share the auditing function where possible.

We are also encouraged by Interior's testimony that the approximately 300 lease accounts showing an amount due the Government of $100,000 or more would be reconciled. A similar effort should also be undertaken to reconcile, to the extent possible, accounts with a credit balance--amounts owed by the Government--and to sample other accounts. We recognize the magnitude of the reconciliation problems, but the work done by the Office of the Wyoming State auditor clearly shows the importance of the work. In just a few months, underpayments of about $4 million were identified and collected.

The Department also indicated in its testimony that a plan for lease inspections would be developed but did not specify when. We were told later that the plan--which is just as important as the auditing plan--would be developed by May 1982. Recent hearings, before various congressional committees and the Commission on Fiscal Accountability, pointed out that the Department's inadequate lease inspections and monitoring have resulted in thefts and lease violations on Federal and Indian lands. The agency provided inadequate coverage--only about 60 inspectors to review the activities at about 44,000 producing wells--a ratio of 1 inspector for every 698 wells. The Department should devote additional resources to the inspection effort and explore the possibility of also sharing this function with the States.

Planning of the production phase

Another problem addressed in our October 6 testimony is Interior's planning for the production phase. This phase is extremely important because the total reliance on information reported by the oil and gas companies must be alleviated. The Department has an overall concept for the production phase but has not developed operational plans or considered how it will interface with other phases of the system. The contractor, in a letter accompanying its offer, stated that the production phase is critical to the improved royalty accounting system and is, itself, so complex in concept and so vaguely defined, that it requires total commitment by both the contractor and the Department of the Interior. In December 10, 1981, testimony before the Commission on Fiscal Accountability, the contractor acknowledged that the development of the production phase is still hampered by many unknowns.

In the request for proposal for the accounting phase, Interior also asked the contractor to determine the data requirements for the production phase, how the information will be used, and how it will interface with the accounting phase. It is the user's responsibility--in this instance, the Interior Department--to outline to the contractor the information needed to make the production phase a viable part of the improved royalty accounting system. For example, the agency must determine whether the production phase will make use of such information as run tickets and meter readings. In addition, it must define how the accuracy of the reported product value will be determined.

Interior officials pointed out that Department personnel are working closely with the system contractor and stated that requirements for the production phase have not been defined because Interior does not want to constrain the contractor's creativity. The Department has hired a consultant to monitor the contractor's progress and to ensure that all milestones are met, and said it will determine the final design of the production phase based on the contractor's recommendations.

Although these actions will help ensure the success of the redesign effort, we are still concerned that the requirements for the production phase have not been sufficiently defined. The most important step in developing a system is determining the requirements, and in our view, it is critical that the Interior Department, as the user, better define its needs. Not only must problems be identified and defined, agency officials must also agree on the scope of the system. Planning is all important in developing and designing an accounting system; a system that is not well planned is not likely to be effective. In its development of the new royalty accounting system, the Department must address the problems in the current system as well as gain control over the data reported by the oil and gas companies.

COMMISSION RECOMMENDS CHANGES IN ROYALTY MANAGEMENT

The Secretary of the Interior established the Commission on Fiscal Accountability of the Nation's Energy Resources in July 1981 because of concerns over the direction of royalty management. The Commission was charged with developing solutions to the mineral management problem, focusing on oil and gas royalty accounting.

The Commission thoroughly examined the royalty management problems and concluded that royalty accounting is in disarray and needs overhauling. In its January 21, 1982, report, the Commission made approximately 60 recommendations for improving royalty collections due from Federal and Indian lands and called for sweeping changes in the organization and direction of royalty management. The Commission addressed the need to:

--Improve internal controls to assure all royalties are collected.

--Improve lease security to preclude the theft of oil from Federal and Indian lands.

--Increase lease inspections and impose sanctions for lease violations.

--Share information and royalty management functions with the States and Indians.

--Remove responsibility for royalty management from the Geological Survey and establish it as a separate entity under the Secretary of the Interior.

These recommendations are discussed in greater detail below.

On March 23, 1982, we testified in support of the Commission's report before the Subcommittee on Interior, House Committee on Appropriations. The Secretary of the Interior also testified in support of the Commission's report. The Secretary pledged to implement the Commission's recommendation and indicated that correcting the longstanding financial management problems that have continually plagued royalty accounting would receive high priority.

Improvements needed in internal controls

The Commission concluded that the present royalty accounting system lacks the basic internal controls needed to assure that royalties are paid when due. The Commission also found that Interior has no systematic means of determining when production begins and, therefore, is unable to ascertain if all royalty payments are received. To preclude the recurrence of such events, the Commission recommended that Interior require that it be notified immediately when production begins on a lease. Also, it recommended that failure to notify the Department should result in a severe penalty. In addition, to assure that all royalties due are collected, the Commission recommended the development of (1) secondary sources of information to verify the volume of production data reported by the oil and gas companies and (2) standardized procedures by which the value of reported production can be determined for the computation of royalties due. These recommendations are in line with our previous proposals for corrective action.

Improvements needed in site security

The Commission concluded that site security on Federal and Indian leases is extremely lax and, as a result, oil is being stolen. The Commission recommended that primary responsibility for site security be placed on the lessee and that each lessee be required to develop a site security plan. Further, it recommended that the Interior Department develop minimum requirements which all security plans must incorporate. In addition, it called for all purchasers to be required to maintain documentation identifying those from whom the oil was purchased--evidence is presently not required. We support these recommendations.

Strengthening sanctions for lease violations

Besides weaknesses in internal controls and site security, the Commission also concluded, as have we, that the lease inspection function was inadequate. Further, it found that sanctions for lease violations are minimal and, even so, rarely imposed and are, therefore, ineffective.

Lease inspections should be an integral part of the financial management structure and should help prevent the theft of oil from Federal and Indian lands. The Commission found, however, that this is not the case. It concluded that too few staff are devoted to the lease inspection function and that inspection results are not shared with accounting. Such a sharing of information would assist in verifying production and would highlight any royalties due that may not have been collected. As a result of its findings, the Commission recommended (1) an increase in the frequency of lease inspections and in the number of inspectors and (2) the reporting of inspection results to the royalty accounting office. We support the Commission in this effort, having long called for such action.

Besides the need to improve inspections, the Commission also reported that the existing sanctions imposed for lease violations are insufficient. The Commission report states that "a lease operator or lessee can violate most site security and royalty accounting requirements with impunity." The Commission, therefore, recommended that the Secretary of the Interior seek legal authority to assess civil penalties for lease violations. The Commission also recommended that the agency exercise its authority to close down production and/or cancel a lease in cases where underpayment is recurring or when the potential for theft is serious. We again support the Commission's recommendations. We noted, however, that the Secretary of the Interior already has the legal authority to impose civil penalties, up to $10,000 for violation of offshore lease provisions. Comparable legislation for violation of onshore leases is, therefore, necessary.

Increased cooperation with States and Indian tribes

The States and Indian tribes have a definite interest in the collection of oil and gas royalties. The States receive 50 percent of the royalty income for oil and gas removed from Federal land within their borders, and the Indian tribes and individual Indian landowners receive all of the royalties collected on minerals removed from their lands.

In testimony before the Commission, the States and various Indian tribes expressed a desire to be more active in royalty management--both in site security and royalty collection. Recently, Interior entered into cooperative audit agreements with two States and it plans agreements with five more. The Commission recommended that this effort be expanded to included Indian tribes and the inspection function but concluded that the Federal Government should retain its oversight responsibility for Federal and Indian leases. As discussed on pages 2 and 4, we have called for audit and lease inspection functions to be shared with the States and for information on production and sales to be exchanged with the States.

The Commission also recommended that the Secretary of the Interior seek legislation establishing a self-sustaining fund that would reimburse the States and Indian tribes for the costs they incur in performing audits and inspections of lease activities. The Commission emphasized that the fund should not be used to pay the normal operating cost of the royalty management program, but rather to pay those costs incurred by the States and Indian tribes in performing audits or lease inspections or in enforcing lease regulations under cooperative or contractual agreements with the Federal Government. The costs incurred by the Government under these agreements could also be charged against the fund.

To establish the fund, the Commission recommended diverting one-half of one percent of royalties collected (onshore and offshore), after deduction of the windfall profit tax where applicable, before any funds are distributed to the States, Indians, or the U.S. Treasury. The yearly budget for the fund would require congressional approval.

In today's environment of budget constraints and reductions, funding of the royalty management program is an important consideration. Improving royalty accounting is not a short term proposition. A significant investment will be required in terms of new systems and additional personnel. The payoff, however, should easily offset these costs. Although we have not studied the proposal, the Commission's alternative is one way of funding this additional effort while providing for congressional oversight. The proposal provides for a sharing of the costs with the States and Indians. But most of the cost burden will fall on the Federal Government since about 75 percent of the royalty collections are related to offshore production for which the States and Indians do not receive a share of royalty income, whereas most of the royalty management problems requiring attention are related to onshore production.

Removal of royalty management from the Geological Survey

Perhaps the most sweeping recommendation the Commission made was to remove the royalty management program from the Geological Survey. In considering possible alternatives, the Commission felt that the royalty management program should be removed because of the Geological Survey's longstanding failings in managing the program--those outlined in our reports going back to 1959.

Because of the revenues involved, the Commission felt that the financial management aspects of the program needed a different perspective--something it did not believe could be accomplished if the program remained in a scientifically oriented organization such as the Geological Survey. Raising the status of the royalty management program was seen as one way of obtaining top quality financial managers. On January 19, 1982, an order was issued by the Secretary of the Interior removing the royalty management functions from the Geological Survey and establishing royalty management as a separate entity.

We have previously recommended that Interior evaluate the need to consolidate mineral management responsibilities. 1/ The organizational changes adopted by the Interior Department in establishing its new Minerals Management Service is consistent with this recommendation.

Our experience has shown that Federal agencies have experienced problems in designing and implementing financial management systems because management attention has been insufficient. In some cases, agencies have spent tens of millions of dollars developing systems which do not adequately work after years of development. Slippages and cost overruns are commonplace. To prevent the improved accounting system from succumbing to the problems encountered by other agencies in designing and implementing systems, a sustained, high priority effort must be put forth. Regardless of whether the function is carried out by a scientifically or a financially oriented organization, an effective accounting and financial reporting system will result only if top agency management remain involved.

1/"Minerals Management at the Department of the Interior Needs Coordination and Organization" (EMD-81-53, June 6, 1981).

SYSTEM COST ESTIMATES NEED UPDATING

Our prior recommendations and the Commission's report provide the foundation for correcting the financial management problems that have plagued royalty accounting for over 20 years. An important area of consideration for the successful implementation of these recommendations is the availability of funds--especially in a period of budget reductions and constraints.

In March 1981 a feasibility study for the new royalty accounting system was completed. That study estimated that the cost of operating the royalty management program would be $208 million over 10 years. This estimate must now be updated. More accurate cost information is available on the cost of the new system--such as the actual cost for contractor services and computer equipment--and proposed personnel staffing estimates have been significantly revised. In addition, the preliminary design of the production phase is not yet complete; when it is, it could represent significant additional costs--costs which are not fully considered in the original cost estimate.

The feasibility study assumed a personnel level of 302 positions by fiscal 1983. This estimate has been revised and current projections now call for 419 positions for the royalty management program by fiscal 1984--an increase in projection of almost 40 percent. However, the increase is even greater since the 419 positions do not include additional lease inspectors or total staffing for the production phase.

The analysis of production information, although considered in the feasibility study, was not portrayed as a major phase of the proposed system, and specific costs for its development were not detailed in the study. An Interior official acknowledged that the March 1981 study considered only input and processing of production reports the agency currently receives, and not the possible inclusion of run tickets or sales receipts which are being considered for use in evaluating the production quantities reported by the oil and gas companies. Another official acknowledged that the total cost of the production phase cannot be estimated until the contractor completes a preliminary design, which is scheduled for March 1982.

The estimated cost for operating the royalty management program must be revised. Overall cost projections have not been updated since March 1981, even though there have been significant changes in cost since that time. In addition, the total estimated cost of designing and implementing the production phase must also be determined.

CONCLUSIONS

The current royalty accounting system is totally inadequate to effectively manage the collection of billions of dollars of royalties due from Federal and Indian leases. Ongoing efforts to redesign the system, coupled with implementation of the recommendations in our October 1981 report and in the January 1982 report of the Commission on Fiscal Accountability, should provide the foundation for resolving the serious longstanding problems.

The problems confronting the Department of the Interior in this area, however, cannot be solved immediately. In today's environment of budget reductions and constraints, it is incumbent upon top management to ensure that the improved royalty management program receives the attention and resources it needs. Without the the necessary people and money, the system for collecting royalties will not likely be improved. In this regard, Interior needs to update its cost estimates for the royalty management program. The current cost estimate does not take into account significant changes in cost that have occurred since the original study was completed.

The Government cannot afford slippage in time or misdirection of resources in this effort. It is critical that the needs and costs be determined as early as possible. We believe that congressional and executive branch oversight are needed to assure that adequate resources are available and that the development of the improved royalty accounting system stays on target.

RECOMMENDATION TO THE SECRETARY OF THE INTERIOR

We, therefore, recommend that the Secretary, no later than September 30, 1982, develop cost estimates, broken out by fiscal year function, for the new royalty management program. This information, which should be furnished to cognizant congressional committees, should include milestones for implementation of specific system improvements and, as a minimum, should detail the cost of personnel, contractor services, and computer equipment for the

--design and implementation of the accounting, production, and enhanced management phases;

--performance of audits;

--lease inspection function; and

--reconciliation of existing lease account records.

OBJECTIVES, SCOPE, AND METHODOLOGY

The Chairman, Subcommittee on Oversight and Investigations, House Committee on Interior and Insular Affairs, requested that we evaluate the development of the new royalty accounting system and determine to what extent it will improve the collection of royalties due from Federal and Indian leases. This review was performed in accordance with GAO's Standards for Audit of Governmental Organizations, Programs, Activities, and Functions.

The primary objective of our review was to ascertain whether the serious financial management problems discussed in our prior reports [1] were addressed in the improved royalty accounting system design and if the system would improve the collection of royalties.

We conducted our review at the Geological Survey Headquarters in Reston, Virginia and at the Geological Survey's Lakewood Accounting Center in Lakewood, Colorado.

At the time of our review, the improved royalty accounting system was being designed and developed and, therefore, our review was limited to the review and analysis of the documentation related to the proposed system. This documention included

--functional and technical specifications for the accounting phase of the improved system,

--contractor proposals and the resulting contract for the design and implementation of the accounting phase and for the preliminary design of the production phase, and

--other management contracts that provide for various support services.

We also reviewed pertinent laws, regulations, policies, and procedures. We interviewed Department of the Interior officials responsible for the planning, design, and implementation of the new accounting system and those responsible for the accounting, auditing, and inspection functions. We also paid close attention to the proposed system's ability to properly account for and collect future, as well as past, royalty payments.

As requested by the Chairman, we did not obtain official agency comments. However, the matters covered in the report were discussed with Department of the Interior and Office of the Inspector General officials and their comments were considered in preparing the report.

---

[1] "Oil and Gas Royalty Collections--Serious Financial Management Problems Need Congressional Attention" (FGMSD-79-24, Apr. 13, 1979) and "Oil and Gas Royalty Collections--Longstanding Problems Costing Millions" (AFMD-82-6, Oct. 29, 1981).

COMMITTEE ON INTERIOR AND INSULAR AFFAIRS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

July 13, 1981

The Honorable Milton J. Socolar
Acting Comptroller General
U.S. General Accounting Office
441 G Street, N.W.
Washington, D.C. 20548

Dear Mr. Socolar:

Since 1959 numerous General Accounting Office and Department of the Interior audit reports have discussed the need for improved management of Geological Survey's royalty collection system. These reports have pointed out the possibility that hundreds of millions of dollars in royalties are not being collected. Furthermore, the reports have disclosed that additional millions of dollars in royalties are not being collected when due, thus increasing the government's borrowing cost.

In a 1979 report to the Congress entitled "Oil and Gas Royalty Collections -- Serious Financial Management Problems Need Congressional Attention" (FGMSD-79-24, 13 April 1979), GAO pointed out that the Geological Survey was having great difficulty accounting for and collecting royalties. In addition, your 13 April 1981 testimony indicated that the Geological Survey's financial management problems that existed 20 years ago are still extant.

In an effort to correct its many longstanding financial management problems the Geological Survey is developing a newly designed royalty accounting system. My staff has discussed with representatives of your Accounting and Financial Management Division our concern as to whether the new system addresses the problems identified in previous GAO reviews. I should like your office to evaluate the new system and associated procedures, and ascertain to what extent it does in fact improve the management of royalty collections. The development effort for this new system is critical to the collection of potentially hundreds of millions of dollars, as well as the expenditure of additional millions for system development and implementation. For these reasons it will impact heavily on the Department of Interior budget authorization and appropriation process. Therefore, I would appreciate an interim briefing by 15 September 1981 and a final report by 1 February 1982.

Sincerely,

Ed Markey

EDWARD J. MARKEY
Chairman
Subcommittee on Oversight
and Investigations
U.S. House of Representatives
818 House Annex #1
Washington, D.C. 20515

REPORT BY THE

Comptroller General

OF THE UNITED STATES

Oil And Gas Royalty Collections-- Longstanding Problems Costing Millions

Since 1959, GAO has been reporting on the need for major improvements in the Geological Survey's oil and gas royalty accounting system. Possibly hundreds of millions of dollars in royalties due from Federal Government and Indian leases are not being collected annually. Although the Geological Survey has readily acknowledged that it is not collecting all royalties due, it has been slow to correct the reported problems.

In an April 1979 report, GAO recommended both short and long range alternatives to the longstanding problems plaguing the system. In this review, GAO determined that the problems not only persist but have become worse. The Geological Survey is now developing an improved royalty accounting system which may be the ultimate solution, but this system will not be fully operational for several years.

UNITED STATES GENERAL ACCOUNTING OFFICE

AFMD-82-6
OCTOBER 29, 1981

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

B-199739

The Honorable Benjamin S. Rosenthal
Chairman, Subcommittee on Commerce,
Consumer, and Monetary Affairs
House Committee on Government Operations

Dear Mr. Chairman:

Your July 9, 1980, letter requested that we follow up on our report titled "Oil and Gas Royalty Collections--Serious Financial Management Problems Need Congressional Attention" (FGMSD-79-24, Apr. 13, 1979). You also asked a series of questions on the financial management of the oil and gas royalty program and the implementation of the Crude Oil Windfall Profit Tax Act of 1980 as it relates to Federal oil.

This report covers our review of the Geological Survey's continued unsuccessful efforts to properly collect oil and gas royalties on Federal and Indian lands and the serious impact of this problem on collection of the windfall profit tax. We testified on these matters before your subcommittee on April 13, 1981.

The Geological Survey is responsible for collecting these royalties and, since April 1980, it also has been responsible for computing and depositing a part of the windfall profit tax levied against oil produced on Federal lands. (Oil production owned or received by the Indians is exempt from the tax.) Royalty collections have increased rapidly in recent years because of substantial increases in oil and gas prices. With oil prices decontrolled on January 28, 1981, this trend can be expected to continue. The Geological Survey has estimated that fiscal 1982 royalty collections will exceed $6.5 billion, and annual royalties could exceed $22 billion by fiscal 1990.

Historically, the Geological Survey has not placed a high priority on collecting oil and gas royalties. Because sufficient management attention has not been focused on correcting deficiencies previously reported, financial management problems existing 20 years ago persist today. As a result, the Geological Survey is not collecting all oil and gas royalties; hundreds of millions of dollars owed the Government may be going uncollected each year. Moreover, millions of dollars in royalty income are not collected when due, thus increasing the Government's interest costs. The Geological Survey's ability to accurately assess and collect Federal royalties also affects the collection of the windfall profit tax associated with those royalties, since the tax is derived from royalties collected.

We recognize that the Geological Survey's task is complex and that it must deal with many factors beyond its control, such as the proliferation of lease interests, varying royalty rates, and complex oil and gas valuation factors. However, other contributing factors can be controlled. The total amount of royalties due has increased tremendously in recent years, increasing the importance of collection.

The Geological Survey is seeking to improve its financial management capabilities by developing a new royalty accounting system, but it will be several years before the system is fully implemented. To be successful, the new system must be given a high priority and sustained effort. However, this system will not provide the information needed to determine previously uncollected royalties or the windfall profit tax due on those royalties. A separate effort will be needed to do that.

We are encouraged by the Geological Survey's decision to finally address seriously the royalty accounting problems that have plagued it for over 20 years. Further, we support the Interior Secretary's establishment of the Commission on Fiscal Accountability of the Nation's Energy Resources. The Commission is charged with developing solutions to mineral management problems with focus on oil and gas royalty accounting--an important step toward resolving the royalty accounting problems.

ROYALTY ACCOUNTING SYSTEM NEEDS IMPROVEMENT

Since 1959, numerous GAO and Department of the Interior audit reports have pointed out the need for improved management of the Geological Survey's royalty accounting system. In our April 1979 report, we recommended both short and long range alternatives. Our followup work shows that the problems discussed in our 1979 report not only persist, but have become worse.

The Geological Survey still relies almost entirely on production and sales data reported by the oil and gas companies. Little effort is made to verify the accuracy of the data supplied. Production reports are not regularly compared to reported sales; communication between Geological Survey accountants and field inspectors is infrequent; lease inspections are not used to verify production. In short, the oil and gas companies are essentially on an honor system to report accurately and pay fully the royalties when due. To alleviate its reliance upon unverified data, the Geological Survey must now begin to determine what secondary sources of data are available among Government and State agencies.

Compounding this near total reliance on information reported by the oil and gas companies was the breakdown of the automated royalty accounting system. Lease account records continue to be inaccurate and unreliable. They cannot be used to determine if royalties are properly computed and paid. For instance, our analysis of 275 randomly selected lease accounts disclosed errors totaling over $1.1 million. These amounts clearly indicate the serious problem the Geological Survey has experienced in maintaining accurate lease account records. We have been reporting on the inaccuracy of lease account records since 1959.

Another longstanding problem centers on the Geological Survey's inability to ensure timely collection of all royalties due. As far back as 1959, we reported that all royalty payments were not received when due. Our current analysis showed that royalties of about $390 million annually were paid late, costing the Treasury about $1.6 million in interest.

In our April 1979 report, we called for interest to be charged on late payments. Although agreeing to do so, the Geological Survey has been slow in acting. Interest was not charged on late payments applicable to offshore leases until September 1980; instructions for charging interest on late payments were not provided to field offices handling onshore oil and gas leases until June 1981; and no interest was collected for onshore late royalty payments until July 20, 1981.

In addition to establishing a reliable royalty accounting system, the Geological Survey must increase its auditing and monitoring of lease accounts, which continue to be ineffective in controlling royalty payments. In fiscal 1980, only 5 percent of the lease accounts were audited nationwide even though those audits proved beneficial by leading to additional collections of over $7.7 million.

The Geological Survey should explore the possibility of sharing its auditing and inspection responsibility and of exchanging information on production and sales with the States. Audits often uncover information that has an effect on other leases, including State and private leases. Information such as this could be shared between Federal and State auditors.

GEOLOGICAL SURVEY IS MAKING AN EFFORT TO CORRECT ITS LONGSTANDING PROBLEMS

To its credit, the Geological Survey is attempting to correct its many longstanding financial management problems. It has established royalty management as a separate entity and has reorganized this function--a recognition of the importance of this area. It has hired about 130 additional personnel for royalty management. Most importantly, it is designing and implementing a new royalty accounting system.

As mentioned previously, the system is not yet operational and will not be for several years. The system is to be implemented in three phases: (1) the royalty accounting phase, (2) the production phase, which will permit the matching of production and sales data, and (3) the enhanced management phase, which will develop quality review and management data. The new system is referred to as a modified Internal Revenue Service (IRS) system because all data submitted will be assumed to be correct subject to extensive computer analysis, screening, and onsite audit. The Geological Survey awarded a contract in September 1981 for the design and implementation of the accounting phase. In addition, the contractor will also be responsible for providing a preliminary design of the production phase. Current estimates are that this first phase will be fully implemented by fiscal 1983 and the second phase by fiscal 1984.

Although we are encouraged by the Geological Survey's ongoing efforts, and many of the longstanding accounting problems have been considered, we are concerned that the agency appears to have not given adequate consideration to

--acquiring data on the number of leases and wells for which it is responsible,

--verifying the royalty computation,

--planning the production phase, and

--developing a comprehensive plan for audits and inspections.

So that its new system does not succumb to the problems encountered by other agencies in designing and implementing new systems, the Geological Survey must give the effort sustained high priority with the long term involvement of top management. An effective accounting and financial reporting system will result only if top management within the Department of Interior and the Geological Survey remain involved. The ongoing impetus to redesign the system must continue.

ROYALTY COLLECTION IS COMPLICATED BY WINDFALL PROFIT TAX

The royalty collection task has been complicated by the windfall profit tax. As you know, the Geological Survey initially had limited responsibilities for computing and depositing the windfall profit tax on certain oil royalties from Federal lands--responsibilities it was unable to handle. As discussed in our April 13, 1981, testimony before your subcommittee, the Geological Survey filed blank quarterly returns for the tax in an effort to comply with IRS regulations requiring that a return be filed. At the time, the Geological Survey could not compute the tax owed and therefore could not complete the return. In January 1981, revised IRS regulations gave the Geological Survey the increased responsibility of computing and paying the windfall profit tax on all oil royalties from Federal lands, beginning in April 1981.

Geological Survey has computed and deposited into a suspense account in the Treasury the amount of windfall profit tax it owed for the 13 months ending March 31, 1981. For the tax due after March 1981, the Geological Survey has been depositing approximately $65 million a month into the Treasury suspense account. This is to be adjusted to the actual tax liability each calendar quarter with the actual tax due when remitted to IRS. However, as of October 16, 1981, no remittance had been made to IRS because the Geological Survey and IRS could not agree on the means by which payment would be made. The Geological Survey wanted to transfer the funds from the suspense account to IRS, while IRS wanted payment by check. It was recently agreed that payment would be made by check. The Geological Survey was not able to tell us when it would make the first payment to IRS.

In addition, the Geological Survey has not filed a return for the quarter ended June 30, 1981. Although the return is due 60 days after the end of the quarter, the Geological Survey has stated that it needs an additional 60 days to complete the return. The agency is in the process of requesting that IRS grant it a 60-day extension.

Another problem that will remain until the Geological Survey's new royalty accounting system is operational and working properly is the accuracy of the royalty computation itself. Since windfall profit tax calculations are based on royalty payments, they will be understated to the extent that royalties are understated and overstated to the extent royalties are overstated.

RECOMMENDATIONS TO THE SECRETARY OF THE INTERIOR

To ensure that development of the new royalty accounting system is given high priority and sustained effort, we recommend that the Secretary of the Interior closely monitor the work to see that the system is properly planned, designed, developed, and implemented. In this regard immediate attention must be given to determining how the production phase will operate and how it will interface with the accounting phase which is currently being designed. Also, in developing the accounting phase, the Geological Survey must acquire data on the number of leases and wells for which it is responsible, and provide for verification of the royalty computation. The necessary resources must be provided and milestones must be strictly adhered to.

We further recommend that, to gain control over information reported by the oil and gas companies, the Secretary direct the Geological Survey to include in its current redesign effort a comprehensive, systematic plan for monitoring, reconciling, and auditing lease account records; inspecting leases; and verifying production and sales data. The plan should provide for (1) establishment of a detailed audit plan for periodic reviews of lease accounts and oil and gas companies' accounting records, (2) devotion of additional resources to the inspection of leases using field inspectors to help verify data reported, (3) coordination with the States to arrange the sharing of the audit and lease inspection function, and the exchange of production and sales information, (4) reconciliation of existing lease account records to the extent possible, (5) identification of staff needs and resources for assessing interest on late payments, and (6) faster deposit of royalty payments using electronic funds transfer when possible.

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Appendix I includes answers to the questions in your letter and other questions raised during our conversations with your office. Your July 9, 1980, letter is enclosed as appendix II. Appendix III lists GAO and Department of the Interior audit reports concerning the Geological Survey's financial management problems. Appendix IV gives the objectives, scope, and methodology of our review. Appendix V explains the windfall profit tax and how it affects the royalties collected by the Geological Survey. Finally, appendix VI lists the estimated royalties and windfall profit tax collections for fiscal 1980 to 1990.

As requested by your office, we did not obtain official agency comments. Unless you publicly announce its contents earlier, we plan no further distribution of this report until 5 days from the date of this letter. At that time, we will send the report to interested parties and make copies available to others upon request.

Sincerely yours,

Milton J. Socolar

Acting Comptroller General
of the United States

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ANSWERS TO QUESTIONS AND RECOMMENDATIONS ON OIL AND GAS ROYALTY COLLECTIONS--LONGSTANDING PROBLEMS COSTING MILLIONS

Following are our answers to the questions raised by the Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, on the Geological Survey's efforts to correct its financial management problems and ensure that all royalties and related windfall profit taxes are collected.

Question 1: GAO has previously reported that the Geological Survey normally does not verify production or sales data and therefore cannot ensure that all royalties owed the Government have been collected. Is this now being done?

Response:

The Geological Survey continues to rely almost entirely on unverified production and sales data reported by oil and gas companies to compute royalty payments due. Little effort is made to verify the accuracy of the information supplied. Production reports are not regularly compared to reported sales; communication between Geological Survey accountants and field inspectors is infrequent; lease inspections are not used to verify production. In short, the oil and gas companies are essentially on an honor system to accurately report and fully pay royalties when due.

We have previously stressed that by matching production data against sales data, the Geological Survey could identify situations where oil and gas produced were not properly accounted for. Although the agency readily acknowledges its inability to determine the accuracy of the lease accounts if production and sales data are not compared, such comparisons are still not being routinely made. For example, one lease we reviewed, for which the well had been in production only 7 months, indicated the Government was owed $239,000. However, we found that most of the $239,000 balance was created by erroneous duplicate reporting of production by the company--an error that could have been detected readily had production and sales data been matched. Since this is normally done only when an account is audited--which is infrequently since only 5 percent of the lease accounts were audited in fiscal 1980--the account could have continued to carry an incorrect balance for some time.

Although the matching of production and sales information is a valuable tool, it has some limitations. Not only is matching sometimes difficult, but in many instances the same company prepares both reports. Therefore, the Geological Survey must have some way to independently verify the data reported. As discussed in our April 1979 report, Geological Survey personnel who periodically inspect well sites can evaluate the reasonableness of the production data. Also, production reports show the quantity on hand and can be analyzed to detect sudden changes in production quantities. This would reduce the Geological Survey's reliance on the oil and gas companies.

Our April 1979 report recommended that field inspectors assist accountants in verifying sales data by determining the reasonableness of inventory and sales data shown on production reports and pointing out discrepancies. The Geological Survey agreed and in April 1979 issued instructions requiring communication and assistance between field inspectors and accountants when inconsistent or questionable data are reported. However, even though the Geological Survey reported 28,283 field inspections during fiscal 1980, we found no indication that field inspectors and accountants have worked together to verify production. Geological Survey officials confirmed that this is rarely done and told us that accountants continue to accept the company reports as accurate. The following comments were made to us by agency personnel:

--Accountants have not been apprised of the results of field inspections in the past couple of years and it is doubtful that any meaningful communications occur between accountants and engineers.

--Accountants are not routinely made aware of inspection results. One official could not remember when a field inspector had notified an accountant about a discrepancy in reported production.

--Accountants must accept what is reported as valid. The inspectors make no attempt to verify production or sales and little communication occurs between inspectors and accountants.

Questions have also been raised about the quality of the lease inspections. The Geological Survey's field inspecting and monitoring were severely criticized at recent hearings before the Senate Select Committee on Indian Affairs; Senate Committee on Energy and Natural Resources; the Subcommittees on Oversight and Investigations and Mines and Mining, House Committee on Interior and Insular Affairs; and the Commission on Fiscal Accountability of the Nation's Energy Resources. During the hearings it was pointed out that because of the Geological Survey's inadequate lease inspecting and monitoring, thefts and violations on Federal and Indian leases have gone undetected. These violations included

--the use of meters that can be reset,

--improper sealing of oil storage tanks and valves,

--inadequate supervision of the lease operations of oil and gas companies, and

--the lack of schematic drawings of oil and gas lines.

At the time of this review, the Geological Survey had only 47 inspectors to review activities at over 44,000 producing wells. This is not enough inspectors to provide adequate coverage. Violations are apt to occur and go undetected. The Geological Survey should devote additional resources to the inspection effort, especially in light of the serious longstanding problems in this area. It should also ensure that the recommendation in our April 1979 report, calling for field inspectors to assist accountants in verifying sales data, is implemented.

Once the production phase of the new royalty accounting system, now targeted for fiscal 1984, is operational the Geological Survey will be better able to compare production and sales data. In the meantime, if the data are not verified and more frequent and comprehensive inspections are not performed, the present near total reliance on data provided by the oil and gas companies will continue for several more years. Further, even after implementation of the new royalty accounting system, the need will remain for verification of this data from a secondary source.

Question 2: Are oil and gas products being properly valued for royalty purposes?

Response:

The Geological Survey, as we previously stated, relies almost entirely on data reported by the oil and gas companies to compute the amount of royalties due and, therefore, is not certain if the correct value is being placed on oil and gas sold. The agency usually accepts without verification the company's reported selling price as the value of the product. Hence, there is no assurance that oil and gas products are being valued properly for royalty purposes.

The problem of product valuation has been a concern since at least February 1972 when we issued a report to the Congress titled "More Specific Policies and Procedures Needed for Determining Royalties on Oil from Leased Federal Lands" (B-118678). Our report pointed out that the Geological Survey did not have adequate criteria to establish the reasonableness of reported oil and gas values. At that time, Geological Survey officials advised us that the policy for determining the amount of royalties due was to simply accept the values reported by the oil and gas companies. Although Department of Interior regulations set forth various factors to be considered in determining the value of oil and gas products, the Geological Survey did not ensure that these regulations were adhered to by the producing companies. In short, the companies were on an honor system.

As further discussed in our April 1979 report, establishing the value of oil and gas is complex. The value for royalty computation should represent the market value, which may or may not be the same as the selling price. In determining the market value of the oil and gas sold, consideration should be given to

- --the various prices charged in a particular area for a certain quality of oil and gas sold,
- --the posted prices in the area, and
- --the actual price paid.

The Oil and Gas Operating Regulations (30 CFR 221.47) state that under no circumstances should the value used to compute oil and gas royalties be less than the gross proceeds from the sale. If the market price is greater than the selling price reported by the companies, it is the Geological Survey's responsibility to determine whether the selling price is "reasonable." 1/

In our current review, we found that oil and gas values were being verified only when a lease account was audited. Since only 5 percent of the leases were audited in fiscal 1980, this leaves quite a void. When verified, oil prices were to be compared to the prices in bulletins published by the oil companies or, in the case of gas, to contract prices. We found, however, that the Geological Survey did not always have the information it needed to verify prices. For example, when questioned about a pattern of widely fluctuating gas prices involving 18 leases during the period January to May 1980, a Geological Survey official stated that he would have to obtain a copy of the sales contract from the company.

Proper valuations of oil and gas prices have been a continuing problem for the Geological Survey. Its Acting Director, in testimony before your subcommittee, estimated that understated oil and gas values cause a loss of about 2 percent in royalty collections each year. This is significant since it means over $54 million may have been lost in fiscal 1980 alone. The Geological Survey needs to assure itself that the values used to compute oil and gas royalties are accurate. However, until the agency can escape its current heavy reliance on oil and gas company data, it cannot ensure proper valuation of royalties.

Geological Survey officials have stated that the new royalty accounting system will provide a means of product valuation. It will be several years, however, before this system will exist. In the meantime, the Geological Survey will have to rely principally on increased lease audits and manual verification of computations to ensure that all royalties due are collected.

1/In the absence of a good reason to the contrary, value is defined in the Oil and Gas Regulations as "reasonable" if it is the highest price paid or offered in fair and open market for the major portion of like quality products produced or sold.

Question 3: GAO has previously reported that the Geological Survey's lease account records contained numerous errors and data omissions and did not accurately reflect the amount of oil and gas royalties owed and collected. Has this problem been corrected?

Response:

The Geological Survey's lease account records are still inaccurate and unreliable--a problem we have been reporting on since 1959. The accounts contain numerous errors and data omissions and cannot be relied on to effectively manage royalty collections. As a result, the Geological Survey and the oil and gas industry cannot use these records to determine if royalties were properly computed and paid.

The Geological Survey maintains account records for oil and gas leases on Federal and Indian lands. Royalties earned and payments made are recorded in the accounts which are maintained by the Geological Survey's automated accounting system using data reported by the oil and gas companies. If the recorded amounts due and the royalties paid do not agree, the account will show a balance. Normally, account balances exist because the companies

--incorrectly compute the amount of royalties owed or paid,

--make an error in reports submitted and used to compute royalties owed or in paying royalties due,

--fail to pay royalties owed, or

--fail to report the data used to compute and record royalties owed or paid.

However, the agency also creates erroneous account balances by recording charges or payments in the wrong account or by making other clerical errors.

Our April 1979 report showed that as of July 1978, the lease account records contained numerous errors and data omissions and could not be relied on to determine the accuracy of royalty collections. On the basis of our recent followup work, we concluded that as of May 1981, the lease account records still are inaccurate.

As discussed in our April 1979 report, the Geological Survey maintained 22,735 lease accounts as of July 30, 1978. Only 6,569 of these did not have a balance. Of the accounts with a balance, 9,497 indicated that the amount paid was greater than the royalties due the Government. Although this condition can result from overpayments by the oil and gas companies, the more frequent reason was that royalties due the Government were understated when company reports were not received, and the charges were not properly entered in the accounts. The balance of these 9,497 accounts amounted to $49.8 million. The remaining 6,669 accounts indicated that royalties of $38.8 million were due because the amounts collected were less than the amounts computed as due.

To determine the accuracy of these accounts, we reviewed 714 randomly selected lease accounts for June, July, and August 1977. We noted the following deficiencies which contributed to the inaccuracy of these basic accounting records.

--In 137 cases, royalty payments totaling $258,000 were recorded in the accounts without corresponding amounts being recorded as due.

--In 245 cases, royalties totaling $471,000 were recorded as due without corresponding royalty payments being recorded.

--In 469 cases, the royalties due did not equal the royalties paid. Royalties paid exceeded the amounts recorded as due by $122,000.

Our current review showed lease accounts are still inaccurate. As of May 1981, 20,356 or 73 percent of the Geological Survey's 27,909 lease accounts had a balance. Of these, 9,320 accounts indicated that the agency had been underpaid by $173 million; the remaining 11,036 accounts indicated, usually erroneously, that the agency had been overpaid by $187 million.

Our followup analysis of 275 of the 714 lease accounts we had previously analyzed, for the 3 months ending June 30, 1980, showed that:

--In 115 cases, royalty payments totaling $725,336 were recorded in the accounts without corresponding amounts being recorded as due.

--In 97 cases, royalties totaling $276,569 were recorded as due without corresponding royalty payments being recorded.

--In 174 cases, the royalties recorded as due exceeded the royalties recorded as paid by $119,226.

These amounts do not necessarily represent underpayments or overpayments, but they clearly indicate the serious problem the Geological Survey has experienced in trying to maintain accurate lease account records. Because of incomplete and inaccurate data in these accounts, they cannot be used effectively to manage royalty collections.

In our April 1981 testimony before your subcommittee, we called on the Geological Survey to develop a plan for reconciling these accounts and for identifying and collecting previously uncollected royalties.

In June 1981, the Geological Survey announced plans to audit accounting records of 20 to 25 oil and gas companies that operate on Federal and Indian lands to determine the amount of underpayments and overpayments that may have occurred. These companies pay over 80 percent of the royalties collected and make up 50 percent of the Geological Survey's lease accounts. The audits will cover transactions for the past 6 years. They are expected to take 3 to 4 years and cost approximately $12 million. The Department of the Interior is now awarding contracts for the first two audits. The results of this work will be used as a basis for determining whether the remaining 20 or so companies are to be audited.

Because of the planned auditing project, the Geological Survey has no plans for reconciling its existing lease account records. We support the plan to audit the oil and gas companies, but feel that more is needed. The agency should also develop a plan to reconcile its lease account records to the extent possible; thereby ensuring proper accountability for hundreds of millions of dollars of royalties.

Question 4: GAO previously reported that the Geological Survey was not collecting all royalties when due and late payments were causing the Treasury to incur additional interest costs. Have these conditions continued to exist?

Response:

Late royalty payments have continued to cost the Treasury potentially millions of dollars in additional interest costs annually. Our analysis of selected lease accounts for the 3 months ending June 30, 1980, disclosed that late payments totaled $98 million for that quarter alone. Had these delinquent payors been assessed interest charges equal to the cost of Federal borrowing, they would have owed an additional $400,000 for the period. Computed for the full year, $390 million in royalty payments may have been paid late, costing the Treasury as much as $1.6 million in additional interest.

Late payments are not a new problem. As far back as 1959 we reported that all royalty payments were not received when due. For instance, our April 1979 report disclosed that in 1977 the Geological Survey did not collect about $359 million in oil and gas royalties when due, costing the Government about $360,000 in interest. We found payments were not received within the time specified in the leases because the agency did not

- --adequately enforce provisions concerning the timely payment of royalties, and
- --impose appropriate administrative fees or interest charges on those making late payments.

As discussed above, our current review has shown that late royalty payments continue to be a problem. Our analysis of 275 randomly selected lease accounts, drawn from the 714 lease accounts examined and reported on in our April 1979 report, showed that late royalty payments for oil and gas sales could have been over $390 million in 1980, costing the Government as much as $1.6 million in interest. Appendix IV details our methodology and sampling plan.

Our current projection for late payments and interest costs is based on the number of leases that existed during our 1979 review--22,735 lease accounts as of July 31, 1978. The number of leases has since grown to 27,909--an increase of almost 23 percent. Hence, it is reasonable to assume that the dollar amounts of late payments and additional interest costs are even greater than projected.

In our April 1979 report, we called for interest to be charged on late payments to encourage prompt reporting and paying. Department of the Interior internal auditors made the same recommendation in 1975. Since the amount of late payments is increasing, it has become more important to charge interest. Although agreeing to do so, the Geological Survey has been slow in acting. Interest was not charged on late payments applicable to offshore leases until September 1980. From then until February 27, 1981, interest assessed on these leases amounted to $55,910, of which $20,438 had been paid. The agency did not provide instructions to its field offices for charging interest on late payments for onshore oil and gas leases until June 1981, and no interest was collected for onshore late royalty payments until July 20, 1981.

Although the Geological Survey has taken the first step by issuing procedures for charging interest on late payments, it must still implement the procedures. Interest should be assessed at the quarterly rate required by the Treasury for delinquent debts. Such assessment could essentially be done automatically--a computer could identify late payments and compute interest charges. However, the present automated system does not have this capability. Until an adequate automated system is developed with this capability, the Geological Survey will have to provide additional staff to manually do the job. For example, officials at the Geological Survey office in Roswell, New Mexico, which processed over 34,000 payments amounting to $19.4 million during November 1980, estimated that six additional employees would be needed to ensure that interest was charged on late payments. Unless the necessary staffing and other resources are quickly identified by the Geological Survey, we doubt that interest can be effectively charged in the near future.

Question 5: GAO previously reported that the Geological Survey was not devoting sufficient resources to auditing lease account records. What has been done to correct this problem?

Response:

The Geological Survey has done very little to correct this problem. Its auditing of lease accounts continues to be inadequate to effectively control royalty payments. As we have reported, without sufficient lease account audits the Geological Survey must rely upon unverified data reported by the oil and gas companies to compute and collect royalties due. Inadequate staffing and special projects have prevented establishment of an effective auditing program. Other initiatives to improve lease account accuracy, such as monitoring newly established accounts and reviewing accounts for obvious errors, were abandoned for similar reasons. Without a viable auditing program, the agency's longstanding financial management problems will continue.

In our 1959 report, we stressed the importance of having an auditing program to identify and resolve deficiencies in the accounting for royalties. We reiterated the importance of auditing in our 1979 report. In 1975 the Department of the Interior internal audit staff also recommended increased emphasis on the auditing of lease account records.

The Geological Survey recognized the importance of comprehensive audits by establishing that an account is to be audited at intervals ranging from once a year to once every 6 years, depending upon the amount of annual royalties paid. Such audits are to represent systematic and thorough investigations and appraisals of such things as reported production and sales, reported values of oil and gas royalties and rentals paid, and compliance with the lease terms and with oil and gas operating regulations. Lease accounts are to be reconciled to identify misapplied or missing charges, underpayments, and overpayments that appear or should appear in the account.

Although it established audit criteria, the agency has not followed through and the situation today is essentially as it was in 1979. In fiscal 1980, only 5 percent of the lease accounts were audited nationwide, although the audits proved beneficial by leading to additional collections of over $7.7 million. Geological Survey officials have acknowledged that audit efforts continue to be inadequate and that they have not been able to audit enough accounts to achieve effective control over them. For instance, the Casper and Albuquerque offices, which are responsible for over 18,000 lease accounts, completed only 92 audits during 1979 and 1980. This means that for those two years, only 1/2 of 1 percent of the total accounts for which these offices are responsible were audited. At this rate, the 18,000 lease accounts will never be completely audited. Even at the fiscal 1980 nationwide rate of 5 percent, it would take 20 years to audit the 18,000 lease accounts in the two offices.

At the time of our 1979 report, the Geological Survey estimated that it would reconcile all lease accounts by 1981.

However, our present work has shown that this task has scarcely been been started.

Overall efforts by the agency to improve monitoring and auditing of accounts have not been successful. Audit coverage is not sufficient in terms of numbers of accounts audited, nor does it provide assurance that accounts most needing audit will be included.

According to Geological Survey officials, the audit and reconciliation requests received from Indian tribes, Federal agencies, companies, and individual lease operators occupy much of the available audit resources. It is difficult for the already burdened audit staff to perform audits of accounts other than those selected on a planned or systematic basis. For example:

--In the Albuquerque office, half the audit staff was working exclusively on royalty-in-kind contracts and on Indian accounts. For one 3-month period, the entire audit staff worked exclusively on Indian accounts because of lawsuits affecting these accounts. We were told that although Indian leases represent 11 percent of the lease accounts, they required 33 percent of the audit resources.

--In the Metairie office, officials stated that an increasing amount of auditing time--presently about 60 percent--is being applied to processing offshore refund requests. These requests, which result when lessees claim to have made an overpayment, require congressional approval. In fiscal 1980, 43 such refund requests were received. In the first 5 months of fiscal 1981, 56 requests have already been received.

Other initiatives, such as monitoring newly established accounts and reviewing accounts for obvious errors, also have not been pursued. As we have repeatedly pointed out, lease account problems can be eliminated or reduced if problems are discovered and resolved early in the life of a new account. The Albuqerque office assigned auditors to monitor newly established accounts but abandoned this effort because of higher priority work. The newly established accounts we reviewed as part of our current work exhibited the same deficiencies as the older accounts. Our analysis of 20 lease accounts, established since July 1979 and with a combined balance of over $250,000, showed that

--payments were not collected when due,

--sales and production reports were filed late, and

--differences existed between amount of royalty paid and amount due.

These problems could have been eliminated had the accounts been monitored.

As discussed on page 7, the Geological Survey plans to audit the accounting records of 20 to 25 oil and gas companies to determine the amount of underpayments and overpayments that have occurred. We support this effort, but believe more is needed. The agency must also develop a plan to reconcile its lease account records to the extent possible.

The Geological Survey also needs to (1) develop a systematic approach to auditing and monitoring lease account activities and (2) identify the additional resources needed to establish and maintain a continuing auditing program. Milestones for completion of the task are needed.

Geological Survey officials stated that to carry out its plans the agency is hiring 130 auditors, accounting technicians, and clerical personnel. According to agency officials, the auditors will be used initially to explain the new royalty accounting system to oil and gas companies. It is not certain that this increase in staff will be sufficient to audit the 27,000 lease accounts for which the agency is responsible. To accomplish as much as possible toward this goal, the auditors must adhere to an established program and should not be routinely used for other work.

Question 6: In your earlier report greater use of computer edit controls was recommended to prevent errors in accounts and to identify problems requiring immediate action. Has this been done?

Response:

Computers that are given adequate and accurate information and are programmed fully can perform a vital function in helping ensure the correctness of information entered in an accounting system. Computer edits can be developed that prevent the system from accepting invalid information.

The Geological Survey's lease accounts contain many errors that could be eliminated, reduced, or identified through the use of computer edits and other computer techniques. The current royalty accounting system, however, still lacks these capabilities.

We noted that the existing royalty accounting system cannot:

--Identify those instances where companies have not included reports for all their leases.

--Provide lists of leases for which royalty payments and charges were not made (indicating that someone did not report), or for which charges and payments did not agree. Such listings would enable the Geological Survey to effectively follow up on nonpayments, late payments, lack of reporting, and erroneous reporting.

--Match the names of those making payments with those who should be paying and reporting on leases. This would help prevent payments from being posted to inappropriate lease accounts.

Many of the problems we identified in reviewing lease accounts could have been pinpointed through computer edits. Geological Survey officials agreed that computer edits of the type mentioned above would assist them in establishing and collecting royalties and said they plan to incorporate needed edits in the new royalty accounting system being developed.

Question 7: Outline briefly the role and responsibility of the Geological Survey and the Treasury Department for ensuring accurate and timely deposit of receipts relative to oil and gas production where the Federal Government has an interest. Identify any failings or shortcomings in this process.

Response:

Oil and gas royalty revenues in general appear to be deposited on time and in accordance with Department of the Treasury requirements. Nevertheless, the Geological Survey could further improve its cash management practices by using electronic funds transfer. This would increase the timeliness of deposits and could reduce the Treasury's borrowing cost.

The Treasury requires agencies to promptly deposit receipts to the general account of the Treasury. Funds are to be deposited no later than the morning of the business day following receipt, but may be held until $1,000 is accumulated and then deposited.

The Geological Survey is solely responsible for ensuring that all royalty revenues are deposited accurately and on time and that allocation of these revenues is properly reported to the Treasury. It is the Treasury's responsibility to record the deposits in appropriate Treasury accounts; it acts as a bookkeeper in that it records deposits to and disbursements from the various Treasury accounts according to information submitted by the Geological Survey.

We observed the cash management practices at the Geological Survey's Roswell office for the week ended January 30, 1981. This office is responsible for collecting and depositing approximately one-third of all royalties received from onshore leases. We found that deposits are sent by certified mail each day to a Federal Reserve Bank and are normally received the following day, thereby meeting Treasury requirements.

Also, we reviewed the cash receipts and deposits for the 15 months ending March 1981 at the Geological Survey's Metairie office, which is responsible for collecting and depositing the majority of royalties from offshore leases. We found that Treasury requirements were met with deposits being hand-carried to the Federal Reserve Bank on the day received. In discussions with Geological Survey officials, we were told that Metairie is the exception. All other field offices use Roswell's method of mailing daily royalty deposits directly to the Federal Reserve Bank. A 1-day difference in depositing amounts of the magnitude collected by the Geological Survey could conceivably cost the Government over $2 million annually in additional interest costs, assuming a 12-percent interest rate and the $6.5 billion of royalties projected for fiscal 1982.

The Geological Survey addressed this issue in the new royalty accounting system design and proposes to deposit the royalty collections into the Federal Reserve Bank the same day as received. All royalty payments will be mailed to the Lakewood, Colorado, office which will prepare and hand-carry the deposit slips directly to the Federal Reserve Bank in Denver. Although this will allow the funds to be deposited into the Treasury more quickly, the Treasury will still have to wait an average of 1 to 2 days for the royalty checks to clear before it has use of the funds. This waiting period could be eliminated through the use of electronic funds transfer procedures.

Under these procedures, oil and gas companies would wire their royalty payments directly to the Federal Reserve Bank, thereby eliminating the check clearing process and giving the Treasury immediate use of the funds. Electronic funds transfer allows instant transfer of funds from virtually any bank in the country to the Treasury. This helps ensure that payments arrive on the due dates so that investments can be made quickly and interest is maximized. The procedure entails obtaining a bank account number for the receipt of the funds and electronically transferring funds to that account on a specified due date. This is done at no additional cost to the Government.

The use of electronic funds transfer could result in significant interest savings to the Government. For example, if the fiscal 1982 estimated royalty collection of over $6.5 billion were made through electronic funds transfer, as opposed to hand-carried daily deposits, the Government could possibly save an additional $2 million to $4 million assuming a 12-percent interest rate. We believe the Geological Survey should investigate with the Treasury the use of electronic funds transfer to deposit royalty collections, especially for the 20 to 25 largest producers of oil and gas on Federal and Indian lands, which pay over 80 percent of the royalties.

Another problem affecting the timely deposit of royalties is the returning of royalty checks. Geological Survey officials stated that from time to time the agency receives checks for which it is unable to identify the lease involved, and consequently sometimes returns the checks to the payer. Officials did not know the magnitude of the problem but stated that action had been taken to ensure that such checks are deposited to the Government's account and the payer then queried regarding the payment.

Question 8: Can the lease royalty rates be changed? If not, what legal action is necessary?

Response:

There are two types of leases: noncompetitive and competitive. All offshore leases are competitive while onshore leases are awarded both competitively and noncompetitively. The royalty rate for noncompetitive leases--presently at 12-1/2 percent--is fixed by statute and would require legislative action for any change. A noncompetitive lease is issued when the land contains no known resource of oil and gas. It is issued through lottery or, if the land has not been leased in the past, in response to an application filed by the party wishing to lease the land.

The royalty rate for competitive leases, on the other hand, is set by statute at not less than 12-1/2 percent and is increased through administrative action. Such a change, however, would not affect the royalty rates of any existing leases, since leases are legally binding upon both parties and mutual consent is necessary to change the rate. A competitive lease is issued when the land is in a known geological structure of a producing oil and gas field. The Geological Survey estimates the lease value and the Bureau of Land Management awards it to the highest bidder, provided the highest bidder is in concert with Geological Survey's estimate of the lease value.

Question 9: Does the Geological Survey identify the various types and quantities of oil produced on Government lands and leases--upper tier, lower tier, tertiary, etc.? Is it capable of doing so to ensure correct royalty and windfall profit tax receipts?

Response:

The Geological Survey requires the lessee to provide information showing

--how much oil was produced,

--what lease or well produced it,

--the quality of the oil produced, and

--the sales price.

As discussed in question 1, however, the Geological Survey relies almost entirely on unverified production and sales data reported by the oil companies. Reported production along with the sales prices is generally accepted as correct and is verified only when a lease is audited, which, as we discussed previously, is seldom done.

Before the enactment of the Crude Oil Windfall Profit Tax Act of 1980, the Geological Survey did not identify the tier from which the oil was produced. The tier category depends upon the date the well began producing the oil and the amount of oil it is producing. These data are now provided to the Geological Survey by the oil companies for computing the windfall profit tax. The sales price gives an indication of the quality. Generally, the higher the price, the better the quality of oil.

Even though the Geological Survey has information available related to quantity, tier, type, and sales price the information is not verified; whatever is reported is accepted as correct. Unless the Geological Survey increases its lease inspections and audits it will not be in a position to verify this information and its reliance upon the oil companies will continue.

Question 10: Does the Geological Survey have the authority to require maximum efficient production from Federal oil and gas leases in order to maximize royalty collections?

Response:

The Geological Survey does not have the authority to unilaterally require maximum efficient production from oil and gas leases in order to maximize royalty collections. The determination of the maximum rate of production for a lease is based on several factors such as energy conservation, efficient utilization of public and private resources, and the royalty rate. The responsibility for establishing production rates is shared by the Departments of Energy and the Interior. In giving the Department of Energy the leadership role in making national energy policy, the Energy Organization Act of 1977 and the Outer Continental Shelf Lands Act Amendments of 1978 state that the Department has the authority to set production rates for Federal leases. That act transferred the Department of the Interior's functions regarding the setting of production rates on individual leases to the Department of Energy. Interior has retained statutory authority for enforcing all leasing regulations, including those relating to production rates. Hence, various provisions in the Oil and Gas Operating Regulations and the existing lease forms contain language to the effect that the rate of production is subject to control by Interior.

We therefore believe that the Congress intended the Departments to share the responsibility for establishing the rates of production for Federal leases, and neither Department has the authority to act alone in this respect. We have previously addressed the coordination efforts between the Departments of Energy and the Interior in leasing Federal energy resources ("Federal Leasing Policy--Is the Split Responsibility Working?" EMD-79-60, June 4, 1979).

Question 11: In light of the Geological Survey's past financial management problems, can it accurately collect and deposit the windfall profit tax?

Response:

Because of the Geological Survey's inability to accurately collect royalties due the Government, there is no assurance that windfall profit tax collections are accurate. Since the windfall profit tax on Federal land is based on the royalty collection system, deficiencies in collecting royalties will be carried over to the windfall profit tax collections. If the royalties are paid late, the tax will be late. If royalties are not reported, the windfall profit tax will not be collected. If the royalty computation is inaccurate, the tax will be inaccurate.

Temporary IRS regulations, issued on April 4, 1980, charged the Geological Survey with responsibility for computing and depositing the windfall profit tax applicable to royalty-in-kind oil revenues. Revenues are classified as royalty-in-kind when, instead of collecting monetary royalties directly from a lease interest, the Government takes a portion of the oil produced by the lessee and sells it to small refineries for processing.

To illustrate, assume 10,000 barrels of oil are produced on a Federal lease having a royalty rate of 12-1/2 percent. If this oil is sold for $400,000, the lessee owes the Government $50,000 in royalties. The Geological Survey can require that the royalty be paid in money or it can take a percentage of the oil as its royalty payment. In the above example, if money payment is chosen, a check for $50,000, less the windfall profit tax is remitted by the oil company. If payment in oil is chosen, the Geological Survey receives 1,250 barrels of oil (12-1/2 percent of 10,000 barrels). After selling the oil to a refinery, the Geological Survey withholds and deposits the appropriate windfall profit tax. Appendix V provides a more detailed explanation of the windfall profit tax as it applies to Federal oil royalties.

Although this is the procedure intended by the tax regulation, it has not always been followed. The Geological Survey had sometimes requested purchasers to withhold and deposit the tax. Because some purchasers withheld the tax and others did not, the Geological Survey could not be sure how much windfall profit tax it was responsible for withholding or how much had been paid on its behalf.

Matters were further complicated because some oil companies were lax in supplying the Geological Survey with the information it needs. Certain data must be furnished by the oil companies, such as oil tier category and base price information, in order for the Geological Survey to compute the windfall profit tax. Before implemention of the windfall profit tax, the oil companies were not required to submit this information to the Geological Survey. Since institution of the tax, however, oil companies not only must report additional information to the Geological Survey, but in some instances must calculate the tax and determine if they are required to withhold it from royalty payments.

Consequently, the Geological Survey did not know how much tax was due from the Federal royalties. It estimated the windfall profit tax applicable to Federal royalties for the 7 months ending September 30, 1980, to be $221 million, but had little support for this figure. As discussed in our April 13, 1981, testimony before your subcommittee, the Geological Survey filed blank quarterly tax returns in an effort to comply with IRS regulations requiring a tax return for the windfall profit tax applicable to royalty-in-kind oil revenue. Since it could not compute the tax owed, it could not complete the return.

In January 1981, revised IRS regulations made the Geological Survey responsible for computing and paying the windfall profit tax applicable to all oil royalties paid the Federal Government beginning in April 1981. Despite its previous problems in computing the tax on royalty-in-kind oil revenue, the Geological Survey asked for the additional responsibility of collecting the tax on all Federal royalties. It issued instructions to its field offices on May 15, 1981, for withholding the tax and is optimistic about its ability to compute and deposit the tax. Amounts withheld will be deposited into a Treasury suspense account and the total will be adjusted to the actual tax liability each calendar quarter. The appropriate tax will then be remitted to the Treasury.

The Geological Survey has computed and deposited into the Treasury suspense account the amount of windfall profit tax it owed for the 13 months ending March 31, 1981. For the tax due after March 1981, the Geological Survey has been depositing approximately $65 million a month into the Treasury suspense account. This is to be adjusted to the actual tax liability each calendar quarter with the actual tax due then remitted to IRS. However, as of October 16, 1981, no remittance had been made to IRS because the Geological Survey and IRS could not agree on the means by which payment would be made. The Geological Survey wanted to transfer the funds from the suspense account to IRS, while IRS wanted payment by check. It was recently agreed that payment would be made by check. The Geological Survey was not able to tell us when it would make the first payment to IRS.

In addition, the Geological Survey has not filed a return for the quarter ended June 30, 1981. Although the return is due 60 days after the end of the quarter, the Geological Survey has stated that it needs an additional 60 days to complete the return. The agency is in the process of requesting that IRS grant it a 60-day extension.

Although there appears to be improvement in the Geological Survey's handling of the windfall profit tax, another problem will remain until the Geological Survey's new royalty accounting system is operational and working properly: accurate computation of the royalty itself. Since windfall profit tax calculations are based on royalty payments, they will be understated to the extent that royalties are understated and overstated to the extent royalties are overstated.

Question 12: In response to your April 1979 report, the Geological Survey is designing a new royalty accounting system. Will this new system correct the Geological Survey's longstanding financial problems?

Response:

The Geological Survey, recognizing that its existing accounting system is inadequate, formed a task force to determine the deficiencies in the system and recommend a course of action for correcting the problems. The task force recommended that a new royalty accounting system be designed and implemented. The new system will not be operational for several years.

The Geological Survey completed a feasibility study and cost-benefit analysis for a new system in March 1981. The system is to be implemented in three phases: (1) the royalty accounting phase, (2) the production phase, which will permit the matching of production and sales data, and (3) the enhanced management phase, which will center on developing quality review and management data.

The Geological Survey refers to the new royalty accounting system as a modified Internal Revenue Service system, because all data submitted will be assumed to be correct subject to extensive computer analysis, screening, and audit. Current estimates are that the first phase will be fully implemented by fiscal 1983 and the second phase by fiscal 1984.

American Management Systems, Inc. was awarded a contract on September 17, 1981, for $4.3 million for the design and implementation of the accounting phase. In addition, the contractor will be responsible for preparing a preliminary design of the production phase. A detailed system design of the production phase is an option of the contract requiring further negotiation between the Geological Survey and the contractor.

As we testified on October 6, 1981, before the Subcommittees on Oversight and Investigations and Mines and Mining, House Committee on Interior and Insular Affairs, it appears that many of the longstanding accounting problems have been considered in the preliminary design of the accounting phase. However, since the contract for the design and implementation of the accounting phase has been awarded only recently, it is too early to tell whether the effort will be successful.

Although we are encouraged by the Geological Survey's ongoing efforts, we testified about our concern that the agency appears to have not given adequate consideration to

--acquiring data on the number of leases and wells for which it is responsible,

--verifying the royalty computation,

--planning the production phase, and

--developing a comprehensive plan for audits and inspections.

Before the Geological Survey can effectively control and monitor royalty collections, its system must have accurate, reliable, and timely information on the number of leases and wells for which it is responsible. Without such information, the agency has no assurance that all individuals who are responsible for paying royalties are in fact making payments.

The Geological Survey, however, has decided to prepare its lease master file--a list of leases and payors--from data in the existing system--data the agency is not certain is complete and accurate. If payors are not listed in the current system, they are unlikely to be listed in the new system data base. In order to obtain information related to the total number of leases it is responsible for, the Geological Survey should consult with the Bureau of Land Management and the Bureau of Indian Affairs. Unless it can maintain exact accountability for leases and payors, the agency will be hampered in its efforts to manage and monitor royalty collections.

Besides determining who should pay royalties, the Geological Survey must also determine the amount due. In the current system the amount of royalties due is computed and compared with the amount paid by the oil and gas companies. If differences occur, as they frequently do, a balance will appear in the lease account. If properly used, this control can provide a means of identifying troublesome lease accounts and companies.

In the new royalty accounting system the Geological Survey will no longer recompute the royalties owed. This will place even greater reliance on the oil and gas companies for the accuracy of the information received, especially since the same company will be submitting both the royalty payment and the sales report. Although some reliance on oil and gas company data will always be necessary the Geological Survey must reduce this reliance to the extent possible and determine the reasonableness of the data reported. By eliminating this control feature, the Geological Survey could be hampering its ability to detect problem lease accounts and/or companies that might be reporting inaccurate or incomplete data.

Another area of concern is the Geological Survey's planning for the production phase. This phase is extremely important because of the need to alleviate the reliance on information reported by the oil and gas companies. The Geological Survey has an overall concept for the production phase but has not developed plans for how this phase is to operate and how it will interface with other phases of the system. The contractor, in a letter accompanying its offer, stated that the production phase is critical to the improved royalty accounting system and is so complex in concept itself, so incompletely defined, that it requires an absolutely all out effort. Priority, however, has been placed almost solely on the accounting phase.

In the request for proposal for the accounting phase, the Geological Survey asked the contractor to also determine the data requirements for the production phase, how the information will be used, and how it will interface with the accounting phase. The Geological Survey is initially relying on the contractor to define the production phase and how it will work. It is the user's responsibility--in this instance the Geological Survey--to outline to the contractor the information needed to make the production phase a viable part of the improved royalty accounting system. For example, the Geological Survey must determine whether the production phase will make use of such information as runtickets and meter readings. In addition, the agency must define the parameters that will be used for determining if the reported product value is accurate.

Geological Survey officials pointed out that agency personnel are working closely with the system contractor and stated that requirements for the production phase have not been defined because the agency does not want to constrain the contractor's creativity. The agency has hired a consultant to monitor the contractor's progress and ensure that all milestones are met, and will make the final determination itself as to the design of the production phase, based on the contractor's recommendations.

Although these actions will help ensure the success of the redesign effort, we are still concerned that the requirements for the production phase have not been defined by the Geological Survey at the outset.

In our view it is critical that the Geological Survey, as the user, better define its needs. The most important step in developing a system is determining the requirements. Not only must problems be identified and defined; agency officials must also agree on the scope of the system needed. Planning is very important in developing and designing an accounting system. If the system is not well planned, its chances for success are diminished.

As discussed previously, we are also concerned that the Geological Survey does not have a comprehensive, systematic plan for monitoring, reconciling, and auditing lease account records; inspecting leases; and verifying production and sales data. The agency has not developed such a plan even though it recognizes the importance of inspections and audits as integral parts of the royalty accounting system and is hiring additional inspectors, auditors and accounting technicians. Under the new system it will be imperative that the Geological Survey seek secondary sources to verify production and sales data. The States are a potential source of this information. The Geological Survey should also coordinate with the States to arrange sharing of the audit and lease inspection function.

Historically, Federal agencies have experienced problems in designing and implementing financial management systems because sufficient management attention has been lacking. In some cases, agencies have spent tens of millions of dollars developing systems that do not adequately work after years and years of development. Slippages and cost overruns are commonplace. So that its new system does not succumb to the problems encountered by other agencies in designing and implementing new systems, the Geological Survey must give the effort sustained high priority with long term involvement of top management. An effective accounting and financial reporting system will result only if top management, within the Department of Interior and the Geological Survey, remain involved. The ongoing impetus to redesign the system must continue.

In this regard we believe the Geological Survey can benefit from the information in two GAO publications. Our May 1979 publication, "Managers, Your Accounting System Can Do a Lot For You," includes a full discussion of how accounting systems can provide information to help managers perform their responsibilities more effectively. A series of case studies illustrates how accounting and financial reporting systems can function as an integral and vital part of an agency's managerial control and decisionmaking process. These case studies are from our experiences in auditing accounting systems and the problems and successes of agencies and consultants in designing and operating accounting systems.

Our August 1976 publication, "Lessons Learned in Acquiring Financial Management and Other Information Systems," focuses on how managers should be involved in system design and implementation projects from initial goal setting through final testing, debugging, and implementation of a new or revised system. Case studies and checklists guide managers through this often complex project and help ensure that the new or revised system will give them the information they need when they need it, and that the goals they set for the system are achieved.

Question 13: The collection of oil and gas royalties is a complex process. What factors contribute to the Geological Survey's difficulty in attaining effective financial management over royalty collections?

Response:

As discussed in our April 1979 report, achieving financial management over the collection of oil and gas royalties is difficult because many factors are involved in determining the amount of royalties owed and who owes them. Failure to consider these factors or errors made in considering them can affect many lease accounts and cause difficult and time consuming problems. In its attempts to determine and collect royalties owed, the Geological Survey must require and handle a large volume of reports on Federal and Indian leases. The workload of processing these oil and gas lessee reports is further increased by the proliferation of lease interests. New lease interests are continually created; existing ones are transferred, reassigned, or sold.

Once a Federal or Indian lease has been awarded, it is common for other parties to become involved in the various activities associated with producing and selling the oil and gas. It is not unusual for as many as eight interests to be involved in a lease. Often each requires a separate lease account. When multiple lease interests sell their portions of the oil and gas produced, any or all may report to the Geological Survey. This proliferation of reports creates a paperwork blizzard for the Geological Survey. Agency officials said an inordinate number of employees are used merely to process the high volume of additional reports created by multiple lease interests. Little time has been available to ensure accuracy or completeness of information.

Determining and collecting royalties is also complicated by unit agreements, in which holders of different leases agree to combine production efforts. Unit agreements (1) introduce more multiple lease interests that may or may not be responsible for reporting oil and gas sales and paying royalties, (2) generate additional leases, (3) necessitate changes in allocating the oil and gas available to the various lease interests to sell, and (4) sometimes introduce different royalty rates.

Finally, several types of leases, containing a variety of royalty provisions, are administered by the Geological Survey. These add another dimension to the complexities faced in determining oil and gas values.

CONCLUSIONS

The Geological Survey's oil and gas royalty accounting system is still fraught with serious financial management problems, although it has been over 20 years since we first reported that the agency could not properly collect all royalties due from Federal and Indian leases. We are most encouraged by the decision to develop a new royalty accounting system. For the first time, the financial management aspects of the royalty program are being emphasized. Such emphasis is long overdue.

It is, of course, too early to tell whether the new system will fully correct the problems. However, if the system is effectively planned, designed, and implemented and if adequate resources are provided, it should enable the Geological Survey to more accurately account for and control royalty payments. Until then, the agency will be hard pressed to fully carry out its responsibilities.

In its develoment of the new system, we believe it is imperative that the Geological Survey not only address the problems in the current automated accounting system but also gain control over the reliability of information reported by oil and gas companies. A comprehensive, systematic plan must be developed for reconciling and auditing lease account records, inspecting leases, and verifying production. Necessary resources must be determined and milestones established. The Geological Survey's existing accounts must also be reconciled.

We emphasize that the problems discussed in this report can be corrected, but only if they are given high priority and sustained effort. The ongoing impetus to redesign the system must continue and improved royalty accounting must receive top management attention for the program to succeed. It will be a difficult job, but it can and must be done. The Geological Survey has established the momentum; it is important that it now follow through with a long term commitment since hundreds of millions of dollars are at stake. The establishment of the Commission on Fiscal Accountability of the Nation's Energy Resources is an important step toward resolving the royalty accounting problems and symbolizes the commitment of the Secretary of the Interior.

RECOMMENDATIONS TO THE SECRETARY OF THE INTERIOR

To ensure that development of the new royalty accounting system is given a high priority and sustained effort, we recommend that the Secretary of the Interior closely monitor the work to see that the system is properly planned, designed, developed, and implemented. In this regard immediate attention must be given to determining how the production phase will operate and how it will interface with the accounting phase which is currently being designed. Also, in developing the accounting phase, the Geological Survey must acquire data on the number of leases and wells for which it is responsible and provide for verification of the royalty computation. The necessary resources must be provided and milestones must be strictly adhered to.

We further recommend that, to gain control over information reported by the oil and gas companies, the Secretary direct the Geological Survey to include in its current redesign effort a comprehensive, systematic plan for monitoring, reconciling, and auditing lease account records; inspecting leases; and verifying production and sales data. The plan should provide for (1) establishment of a detailed audit plan for periodic reviews of lease accounts and oil and gas companies' accounting records, (2) devotion of additional resources to the inspection of leases, using field inspectors to help verify data reported, (3) coordination with the States to arrange the sharing of audit and lease inspection functions and the exchange of production and sales information, (4) reconciliation of existing lease account records to the extent possible, (5) identification of staff needs and resources for assessing interest on late payments, and (6) faster deposit of royalty payments, using electronic funds transfer when possible.

NINETY-SIXTH CONGRESS
Congress of the United States
House of Representatives
COMMERCE, CONSUMER, AND MONETARY AFFAIRS
SUBCOMMITTEE
OF THE
COMMITTEE ON GOVERNMENT OPERATIONS
RAYBURN HOUSE OFFICE BUILDING, ROOM [illegible]
WASHINGTON, D.C. [illegible]

JUL 11 1980

July 9, 1980

Mr. Donald L. Scantlebury
Director
Financial and General Management
Studies Division
General Accounting Office
441 G Street, N.W.
Washington, D. C. 20548

Dear Mr. Scantlebury:

The subcommittee which I chair, the Subcommittee on Commerce, Consumer, and Monetary Affairs of the House Government Operations Committee, has oversight responsibility for financial transactions involving the U.S. Treasury. Government activities which directly bear on or influence U.S. revenues are therefore of continuing interest to the subcommittee. On April 13, 1979, GAO issued a report entitled "Oil and Gas Royalty Collections -- Serious Financial Management Problems Need Congressional Attention" (FGMSD-79-24) the work for which was accomplished under your direction. I am requesting that you update your study and report in writing to the subcommittee your findings as to the following:

1. Does the Geological Survey now adequately measure the amount of oil produced on Government lands to ensure complete and accurate royalty billing?

2. Does the Geological Survey identify the various types and quantities of oil produced on Government lands and leases, i.e., upper tier, lower tier, marginal, tertiary, etc.? Is Geological Survey capable of doing so to ensure correct royalty and tax receipts to the U.S. Treasury?

3. Outline briefly the Geological Survey's and the Treasury Department's role and responsibility for ensuring accurate and timely deposit of receipts relative to oil production where the Federal Government has an interest. Identify any failings or shortcomings in this process.

4. To what extent do present laws, regulations and contracts permit the Federal Government to control or influence the rate of oil production on federally leased lands so as to ensure maximum systematic royalty collections? To the extent these exist, have they been appropriately used by the Geological Survey?

5. Since the royalty payment is based on the price of the oil, it is imperative that a fair and accurate method exist for determining the price of the crude oil. Explain the existing process of pricing the crude oil produced on Federal lands. How does the price of oil produced on Federal lands compare to the market price of comparable quality crude oils sold in "arms-length" transactions? How does it compare to the "landed cost" of comparable crude oils? Does the existing pricing mechanism permit integrated firms to reduce the transfer price of the crude oil for royalty payment purposes?

6. Can the payment mechanism be changed? If so how, and by whom? Has this occurred in the past, and why?

Please respond by September 30, 1980. Owing to the time constraints faced by the subcommittee and the timeliness of the issues involved, I request that you respond to this request by letter (rather than by issuing a formal report) on or before September 30, 1980. Please be advised as well that you may be asked to testify before my subcommittee this fall. If you have any questions please contact Mr. Peter S. Barash (225-4407).

Sincerely,

Benjamin S. Rosenthal
Chairman

BSR:av

GAO Note: It was subsequently agreed with the Chairman's office that we would testify on the Geological Survey's collection of oil and gas royalties and the impact on payment of the windfall profit tax on April 13, 1981, and issue a final report by October 1981. Also, as agreed with the Chairman's office, questions 4, 5 and 6 have been modified or deleted and additional questions added concerning the Geological Survey's system for collecting oil and gas royalties.

Problems at Geological Survey Reported On by GAO and Department of Interior Internal Auditors

Problems	Reported by	
	GAO	Internal auditors
Reliance on oil and gas company data for computation of royalty payments	December 1959 February 1972 April 1979	June 1975
Inaccurate lease account records--large debit and credit balances distorting accounting records	December 1959 April 1979	June 1975
Inadequate audits and reconciliations of lease accounts	December 1959 April 1979	June 1975 February 1977
Royalties collected late or not collected in full	December 1959 April 1979	June 1975
Charging interest on late payments	April 1979	June 1975
Sales and production data not verified	February 1972 April 1979	June 1975 February 1977
Inadequate valuation of oil and gas prices for royalty purposes	February 1972 April 1979	June 1975 May 1980
Staffing problems not adequately addressed	April 1979	June 1975

OBJECTIVES, SCOPE, AND METHODOLOGY

The Chairman, Subcommittee on Commerce, Consumer, and Monetary Affairs, House Committee on Government Operations, requested that we follow up on our report titled "Oil and Gas Royalty Collections--Serious Financial Management Problems Need Congressional Attention" (FGMSD-79-24, Apr. 13, 1979). The Chairman also asked a series of questions on the financial management of the oil and gas royalty program and the implementation of the Crude Oil Windfall Profit Tax Act of 1980 as it related to Federal oil.

The objectives of our review were to

--follow up on our April 1979 and earlier reports which identified deficiencies in the Geological Survey's collection of oil and gas royalties, and

--determine the impact of the Crude Oil Windfall Profit Tax Act of 1980 on the collection of royalties.

We conducted our review at the following U.S. Geological Survey locations:

--Headquarters, Reston, Virginia

--Eastern Area Office, Washington, D.C.

--Gulf of Mexico - OCS Operations Area Office, Metairie, Louisiana

--Northern Rocky Mountain Area Office, Casper, Wyoming

--Southern Rocky Mountain Area Office, Albuquerque and Roswell, New Mexico

--Western Area Office, Los Angeles, California

We reviewed pertinent laws, regulations, policies, and procedures. We interviewed Geological Survey officials responsible for the planning, designing, and implementation of the new accounting system and those responsible for the accounting, auditing, and inspecting functions in the present accounting system. We concentrated on the deficiencies in the Geological Survey's present accounting system and the controls over and accuracy of the royalty collections. We also gave close attention to the proposed system and its ability to properly account for and collect future, as well as past, royalty payments. We discussed our work with the Inspector General staff of the Department of the Interior and considered the findings in their audit reports pertaining to the royalty collection program.

As requested by the Chairman, we did not obtain official agency comments. However, the matters covered in the report were discussed with Department of Interior and Geological Survey officials and their comments were considered in preparing the report.

Sampling methodology

We used statistical sampling to select lease account records, which we then reviewed for errors and for estimating the number and dollar amount of late royalty payments and the additional interest costs incurred by the Government because of late payments. We assumed that, had late royalty payments been received when due, the Treasury's borrowing could have been reduced.

The information in our 1979 report was based on a sample of 714 lease accounts randomly selected from the total 22,735 lease accounts maintained by the Geological Survey on July 31, 1978. This followup work is based on royalty payments for oil and gas sales during April, May, and June 1980 on 275 lease accounts randomly selected from the 714 lease accounts reported on earlier. Because the 275 accounts were randomly selected from another random sample, the information obtained from them can be used to draw conclusions about only the 22,735 lease accounts. Selecting from the sample used earlier allowed us to expedite our followup review.

Statistical sampling enables us to draw conclusions about the universe of interest from information contained in a sample of that universe. The results are always subject to some uncertainty, or sampling error, because only a portion of the universe has been selected for analysis. The sampling error consists of two parts: confidence level and range. The confidence level indicates the degree of confidence that can be placed in the estimates derived from the sample. The range is the upper and lower limits between which the actual universe value will be found. The results of our calculations for the 3-month period are shown below.

	Universe estimate	Range at 95% confidence level		
		Lower limit		Upper limit
Value of late payments	$98 million	$64 million	to	$133 million
Number of late payments	19,589	17,026	to	22,152
Interest costs	a/$409,000	$209,000	to	$609,000

a/ In computing this cost, we used the 11.96-percent interest rate for the 3-month market yield on U.S. Government securities for calendar 1980, as reported by the Government Finance Section of the Federal Reserve Board.

EXPLANATION OF THE CRUDE OIL WINDFALL PROFIT TAX ACT OF 1980 AS IT APPLIES TO FEDERAL OIL ROYALTIES

The Crude Oil Windfall Profit Tax Act of 1980 was enacted on April 2, 1980. The act imposes an excise tax on domestically produced crude oil removed from the leased wells after February 29, 1980. The tax is levied on the difference between the adjusted base price and the sales price of the oil. Basically the law

--taxes the excess of the sales price of a barrel of oil minus the adjusted base price;

--levies a tax rate applicable to the category or "tier" of the taxable crude oil, and

--exempts from the tax the oil attributed to qualified government interests, qualified charitable interests, certain Indian oil, and certain Alaskan oil.

Revenue generated by the tax is to be used for income tax reductions (60%), low-income assistance (25%), and energy and transportation programs (15%).

Temporary IRS regulations, issued on April 4, 1980, charged the Geological Survey with responsibility for computing and depositing the windfall profit tax applicable to royalty-in-kind oil revenue. Revenues are classified as royalty-in-kind when the Government, instead of collecting monetary royalties directly from the lease interest, takes a portion of the oil produced under a Federal lease and sells it to small refineries.

The Geological Survey had limited responsibilities for computing and depositing the windfall profit tax on oil royalties generated from Federal land between March 1, 1980, and March 31, 1981. At its own request, it was given the added responsibility for collecting and depositing the windfall profit tax on all Federal oil starting with the April 1981 production month.

For the Geological Survey to compute the windfall profit tax, it must receive from the oil companies the sales price, base price, and tier category of the oil. Before passage of the act, the Geological Survey did not require such data. The volume of data it must process has now greatly increased.

The windfall profit is determined by subtracting the base price from the sales price of the oil sold. The tax is then calculated by applying a tax rate applicable to the tier category to the windfall profit. There are three tier categories, two of which have subclassifications. There are also four different tax rates varying from 30 to 70 percent. The windfall profit tax is not in addition to the royalty collection--it is assessed on the royalty and subtracted from the oil royalties collected by the Geological

Survey. A specific portion of the royalties is returned to the State, based upon the type of land leased. In most instances, 50 percent of onshore oil royalties is distributed to the State in which the lease is located, and 50 percent is placed in the Treasury, which in turn redistributes it to other Government activities based upon instructions received from the Geological Survey. In effect, the tax reduces the amount of money that would have been distributed to the States and Government. In the case of an offshore lease, the States do not share in the royalties.

The following hypothetical example shows how the windfall profit tax is calculated and its effect on the distribution of royalties for an onshore lease.

Assume a lease is producing oil at the rate of 5,000 barrels a month and is located on federally leased public land. The base price of the oil is assumed to be $13 a barrel, the royalty rate is 12-1/2 percent, and the oil was sold for $38 per barrel. The windfall profit tax rate is 70 percent.

	Pre-windfall profit tax	Post-windfall profit tax
Gross proceeds (5,000 barrels x $38)	$190,000	$190,000
Royalty rate	12-1/2%	12-1/2%
Royalty owed the Government	$ 23,750	$ 23,750
Windfall profit tax due the Government [($38 - $13) x 5,000 x 12-1/2% x 70%]	-	($10,938)
Amount of royalty available for distribution	$ 23,750	$ 12,812
To the State	$ 11,875	$ 6,406
To the Treasury	$ 11,875	$ 6,406

For an offshore lease, the effect of the windfall profit tax would be different. Royalties from these leases are all deposited in the Treasury, not distributed to the States. Assuming the same situation, except with a royalty rate of 16-2/3 percent, the impact of the tax on royalties collected from an offshore lease would be as follows.

	Pre-windfall profit tax	Post-windfall profit tax
Gross proceeds (5,000 barrels x $38)	$190,000	$190,000
Royalty rate	16-2/3%	16-2/3%
Royalty owed the Government	$31,673	$31,673
Windfall profit tax due the Government [($38 - $13) x 5,000 x 16-2/3% x 70%]	-	($14,586)
Royalty available for distribution to other Government activities	$31,673	$17,087

SOUTH HAMPTON REFINING CO.
POST OFFICE BOX 1636
SILSBEE, TEXAS 77656

April 29, 1982

The Honorable James A. McClure
Chairman
Committee on Energy and Natural Resources
c/o Mr. Tony Bevinetto
3204 Dirksen Senate Office Building
Washington, D. C. 20510

Re: S-2305

Dear Senator McClure:

I am writing to express my strong opposition to Section 12 of S-2305. Section 12 would retroactively exempt the Unites States Geological Survey (USGS) from the Emergency Petroleum Allocation Act, and the regulations promulgated thereunder, and would immunize USGS from any lawsuit seeking recovery of overcharges from USGS. We believe Section 12 to be extremely unfair, unnecessary, and in conflict with prior Congressional enactments.

South Hampton Refining Co. owns and operates a crude oil refinery located in Silsbee, Texas. South Hampton is a "small refiner" as that term is defined in Section 3 of the Emergency Petroleum Allocation Act. South Hampton does not produce any of the crude oil which it refines and, therefore, must purchase all of its crude oil from other sources. Accordingly, South Hampton is also an "independent refiner" as that term is defined in Section 3 of the EPAA. South Hampton also qualifies as a "small-business concern" under Section 3 of the Small Business Act because it is independently owned and operated and is not dominant in its field of operation.

Since 1973 South Hampton has entered into three contracts for the purchase of royalty oil from the USGS from leases on the Outer Continental Shelf of the State of Louisiana. In performing these contracts, USGS charged South Hampton $3.7 million more than was permitted under applicable Department of Energy pricing regulations. USGS violated these regulations by engaging in the following conduct:

1. Charging South Hampton an administrative fee of one-half percent of the "market price" per barrel, over and above the maximum lawful selling price under the regulations, for each barrel sold to South Hampton;

2. Selling volumes of crude oil to South Hampton without any certification whatsoever regarding its classification under the price control regulations;

3. Recertifying volumes of crude oil as "upper tier" more than 60 days after such crude oil has been produced and sold;

4. Imposing price increases for crude oil sold to South Hampton after the end of the calendar month during which the crude oil was produced and sold; and

5. Requiring South Hampton to bear the cost of transporting the crude oil from the lease to the shore.

Section 12 of S-2305 would immunize USGS from liability for such overcharges. USGS must not be permitted to evade this liability.

At the outset, USGS voluntarily obligated itself to comply with applicable pricing regulations All three contracts between USGS and South Hampton, which were USGS form contracts, provided:

> It is understood and agreed by and between the GOVERNMENT and the PURCHASER that this agreement shall be subject to all war of emergency laws of Congress now or hereafter enacted and to all valid orders, rules, and regulations issued pursuant to such laws ....

The Emergency Petroleum Allocation Act plainly is an "emergency" law enacted by Congress. Moreover, the third contract between USGS and South Hampton, entered into in 1980, expressly provides that the contract price for the royalty oil shall be the "regulated price," and defines "regulated price" as

> the highest price ... at which oil may be sold pursuant to the Emergency Petroleum Allocation Act of 1973 ... and any rule or order issued under such Act ....

Section 12 of S-2305 would abrogate South Hampton's rights under the contracts and would permit USGS to evade contractual terms, which it wrote, and to which it obligated itself.

Enactment of Section 12 of S-2305 would effectively repeal Section 4 of the EPAA, which provides that the price and allocation regulations issued by the Executive Branch "shall apply to all crude oil ... produced in or imported into the United States."

Section 12 of S-2305 would nullify 10 C.F.R. § 212.52, which provided that, during the period of price controls:

> The prices charged for any sale of a covered product by any Federal Department, agency, or other instrumentality ... are subject to the price regulations ....

39 Fed. Reg. 12252 (February 4, 1974).

Enactment of Section 12 of S-2305 would repeal the 1978 Amendment to the Outer Continental Shelf Lands Act ratifying the regulation that subjected crude oil and petroleum products sold by federal instrumentalities to the DOE's price control regulations:

> The Secretary ... may offer to the public and sell by competitive bidding for no more than its regulated price ... any part of the oil obtained by the United States pursuant to any lease as royalty or net profit share ....

43 U.S.C. § 1353 (b)(1) (emphasis added). The term "regulated price" is defined as

> the highest price ... at which oil many (sic) be sold pursuant to the Emergency Petroleum Allocation Act of 1973 and any rule or order issued under such subchapter ....

43 U.S.C. § 1353 (e)(1). The Act goes on to provide:

> The Secretary may only sell or otherwise depose of (offshore federal royalty oil) ... in accordance with any provision of law, or regulations issued in accordance with such provisions, which provide for the Secretary of Energy to allocate, transfer, exchange, or sell oil in amounts or prices determined by such provision of law or regulation.

43 U.S.C. § 1353(b)(3).

There is no valid policy justification for retroactively excusing USGS from compliance with the DOE pricing regulations. While it may have been burdensome and bothersome for USGS to have complied with the regulations, such compliance was not more burdensome for USGS than it was for industry -- especially small companies such as South Hampton having limited resources and personnel. Officials of the Department of Energy have reassured members of Congress on numerous occasions that there will be no amnesty for price control violations by industry. We see no reason why there should be amnesty for USGS.

Very truly yours,

Ronald Renz

Ronald Renz
President

RR/cap

April 26, 1982

A COMMENTARY ON THE REPORT OF THE COMMISSION ON FISCAL ACCOUNTABILITY OF THE NATION'S ENERGY RESOURCES

by the

AMERICAN PETROLEUM INSTITUTE

On January 21, 1982, the Commission on Fiscal Accountability of the Nation's Energy Resources (hereafter "The Commission") issued its report of findings in an investigation which began on July 17, 1981. The report includes 60 recommendations which are intended to improve revenue accountability and security of oil and gas production from Federal and Indian lands. The report and its recommendations are based on testimony taken at hearings, on other government reports, on various written communications and other sources. While the language in the report itself is moderate, it contains many conjectural, unsupported statements which have led to unfounded charges of wholesale cheating, stealing and fraud by the oil and gas industry.

It is the purpose of this analysis to examine the information collected by the Commission and make an assessment of the implications of that data. This commentary is intended to be used by API as a resource in responding to requests for information, in appearances at various hearings, and as resource material in the improvement of the handling of government interests in oil and gas produced from government lands. This commentary is intended to present observations based on an examination and evaluation of the same data and reports used by the Commission. For the sake of consistency with the Commission's report, this analysis will refer to USGS as the government regulator rather than the new Minerals Management Service.

The American Petroleum Institute (API), which includes among its members hundreds of oil and gas producing companies of all sizes and thousands of their employees, is deeply concerned about many of the implications in the Commission's report as well as the conclusions reached by the Commission. We agree that the opportunity for theft and fraud exists in the oil and gas producing business. API, with industry, is committed to assist in reducing to a minimum all such theft and fraud and is working toward that end. API believes, however, that many of the implications in the report are overstated, being based on estimates extrapolated from an extremely small data base and on undocumented allegations and reports.

According to its official charter the Commission was to:

a. Examine the allegations of waste and loss of minerals royalty revenues due the Federal Government, States, and Indian tribes.
b. Evaluate and recommend improvements to the Department's royalty management system, and
c. Recommend improvements in the internal controls in areas related to revenues generated from Federal and Indian lands.

The Commission's report drew on a variety of sources for the information on which to base its recommendations. The index to the Commission's record contains 221 entries ranging from hearing transcripts, through Government Accounting Office reports from 1979 and 1981, to individual letters. Testimony was not presented under oath and opportunity was not provided for cross-examination or rebuttal. Most of the opinions and conclusions contained in the hearings record are not well documented. In fact, the report recognizes this deficiency and contains this qualifying statement--"The estimates (of the amount of underpayment) rest on a small base--internal audits that have been conducted by government agencies and a private company.* To recognize that royalty underpayment exists is not to say that oil and gas companies intentionally defraud the land owners. Underpayment often results from a defensible interpretation of a complex set of rules." Therefore, much of the basis on which many of the allegations are made and on which many of the recommendations rest is of questionable value.

Much of the Commission's report, and the Government Accounting Office report which supports it, deals with so-called "underpayments" of royalty as though it was revenue forever lost to the government. In reality, much of this "underpayment" represents known, open and defensible disagreements between various producing companies and the government over the pricing of natural gas (not including crude oil), whether sold or consumed in various lease uses. The opportunity for such disagreement exists in large part because of complex pricing regulations and the related difficulty in establishing the fair market value of production which are the consequence of the Natural Gas Policy Act of 1978 and thus have some of their root in an act of Congress. An example, illustrative of the complexity of the gas pricing problem, is attached as Exhibit I. Some of the disputes arose from internal problems in the USGS onshore royalty accounting system which have been recognized for many years by the USGS, even to the extent that attempts were made to budget additional resources to handle these deficiencies. These budget initiatives until very recently had not been successful so some of the problems identified by the Commission can be attributed to the government budget apparatus, not to the scientists and technical people of USGS.

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*Emphasis added.

The report carries many quotations from old investigations which suggest underpayment and fraud. Data from those reports is presented with qualified conclusions -- something "might" have occurred, "may" be going uncollected, etc. It loosely equates underpayments with suggested royalty losses. As support for many of its conclusions the report includes a tabulation of the results of "selected" audits, eleven of which are presented in the Commission's report in Exhibit E. These are listed in Exhibit II, attached hereto, together with clarifying comments on the nature of the so-called underpayments and the current status of the disputes. This current status was not described in the Commission's report.

The level of royalty underpayment is frequently quoted as ten per cent of the royalties due, a figure which apparently had its origin in a Government Accounting Office report which cited "the experience of a large private oil

SCHEDULE OF GEOLOGICAL SURVEY ESTIMATED ROYALTY

COLLECTIONS FOR FISCAL 1980-1990
(millions)

	Outer Continental Shelf				Onshore oil and gas				Onshore mining			
Fiscal year	Oil	Windfall profit tax	Gas	Total	Oil	Windfall profit tax	Gas	Total	Coal	Other	Total	Grand total
1980	$ 723	$ (145)	$ 1,222	$ 1,945	$ 439	(76)	$ 239	$ 678	$ 33	$49	$ 82	$ 2,705
1981	1,375	(480)	1,600	2,975	633	(190)	314	947	39	55	94	4,016
1982	1,679	(840)	3,334	5,013	774	(333)	644	1,418	48	59	107	6,538
1983	1,785	(893)	5,101	6,886	824	(355)	992	1,816	58	59	117	8,819
1984	1,920	(960)	6,935	8,855	886	(382)	1,351	2,237	69	60	129	11,221
1985	2,076	(1,038)	8,835	10,911	969	(414)	1,713	2,682	148	62	210	13,803
1986	2,250	(1,125)	9,719	11,969	1,051	(450)	1,911	2,962	181	64	245	15,176
1987	2,364	(1,182)	10,602	12,966	1,115	(474)	2,098	3,213	427	66	493	16,672
1988	2,495	(1,247)	11,702	14,197	1,178	(502)	2,319	3,497	597	68	665	18,359
1989	2,600	(1,300)	13,503	16,103	1,240	(525)	2,733	3,973	699	70	769	20,845
1990	2,714	(1,357)	14,670	17,384	1,297	(550)	2,973	4,270	864	72	936	22,590

NOTE: Windfall profit tax applies only to oil.

and gas company which audits oil and gas leases" which "show that royalties due are normally understated by 7 to 10 per cent."* A more accurate quotation from that company (which is not large by industry standards) is that "Experience has shown that as much as* 7% to 10% underpayment of royalties each year do occur mostly due to such [royalty accounting] errors." (Parenthetical notations added.) API believes that "as much as" should not be construed as "normally". The Inspector General of the Department of the Interior in his testimony before the Commission estimated a 3 1/2 per cent underpayment. However, even his estimate of a "3 1/2 per cent royalty loss rate" is questionable because it is based on an acknowledged difference between what the USGS said the value of gas should be and what the FERC allowed the price to be. (See Exhibit II.)

As indicated by Exhibit II, the alleged "underpayments" would be much better characterized as "disputed payments." They occur because of legitimate disagreements, and no effort is made to hide the differences. Furthermore, contrary to statements that have been made, there have been overpayments and they have been brought to the Commission's attention.

The report lays stress on the fact that the government may have lost some interest on underpaid or late accounts, but it does not note that this may be offset to a considerable extent by interest earned on overpaid accounts. The Commission's report does recognize overpayments by implication, at least offshore, in a recommendation that Congress change the time-consuming process through which they obtain refunds.

*Emphasis provided.

We believe that operations and alleged problems on offshore Federal lands can and should be viewed differently from those onshore. Offshore and coastal water operations are significantly different from operations onshore. Offshore operations require that treating, compression, and metering facilities, and often well heads, be clustered on platforms, and are accessible only by boat or helicopter, thus they offer a maximum of site security and little opportunity for theft. Onshore, well heads and other facilities are scattered, some in remote locations, measurement and custody transfer facilities are often not sophisticated, are usually easily accessible by car or truck, and thus would be more susceptible to theft. Also, there is a widely differing spectrum of companies operating offshore where there are on the order of only 2,000 leases, compared with 17,500 onshore leases. USGS has recognized these operational differences in dividing regulatory responsibility between Marine Operations and Onshore Operations.

The "irregularities" reported by the Commission on OCS activities deal almost altogether with so-called "underpayment" of royalty on gas production and relate to undervaluation of or disputes over the royalty paid on gas used as fuel, etc. There are no allegations in the report of theft from OCS leases which produce 76% of all oil and gas royalties from federal and Indian lands nor are there Indian lands involved. As indicated in Exhibit II, many of the underpayments alluded to in the report are not the consequence of willful wrongdoing but rather represent legitimate disagreements or incorrect interpretations which will be settled through established appeals processes. Altogether the allegations of underpayment of OCS royalties in the

Commission's report totals $11,100,000. Once these disagreements or interpretive questions are resolved there should be no remaining 'underpayments". No further mispayments of those accounts would occur until or unless other "pricing" or "interpretation" disputes occur. That does not say, however, that other disagreements (together with associated different payment values) will not arise in different accounts.

There is little, if any, evidence that accountability for offshore production which account for the 76% of all government and Indian royalties is inadequate. To the contrary, offshore production lends itself to sophisticated metering of production and to reliable computerized accounting systems. These systems, together with the USGS system of handling OCS production and royalty data, appear adequate to identify instances of possible irregularities. Indeed, many of the numbers and/or audit selections incorporated into the Commission's report were probably generated by those systems.

On Federal and Indian lands onshore which account for only 24% of the oil and gas royalties from federal and Indian lands, royalty losses due to both theft and underpayment have been alleged. Regarding theft, very little documentation exists to permit assessment of the magnitude of the problem. Most of the references to theft in the report are merely observations or unsupported estimates. One estimate is that 3 to 6% of all oil produced (including that offshore) is stolen. This would indicate that in 1980 between 86,000,000 and 172,000,000 barrels were stolen--a volume that would require between 430,000 and 860,000 200-bbl tank truck loads of oil to move on the nation's roads--an incredible amount to go undetected if, as is believed, most stolen oil moves by truck.

Alleged underpayments, applicable to onshore production are largely the result of disputes over valuation or use of gas or oil similar to the disputes offshore or to inadvertent accounting errors. The valuation process, in many instances is especially complex because of the complex pricing regulations for gas and oil and uncertainty stemming from Government rulings regarding prices. Investigation of the one major alleged underpayment noted in the Commission's report (a $10,000,000 audit exception, see Exhibit II), reveals that the company is caught between a USGS interpretations and an FERC ruling on gas prices. If the FERC ruling is upheld in the appeals process, the "underpayment" will disappear.

Exhibit III, hereto, presents API's comments on selected recommendations from the 60 presented in the Commission's report. Of those recommendations, it is believed that 27 of them relate to internal operations of the Department of the Interior and its royalty management system and these are not treated in this report. Of the 33 recommendations covered in Exhibit III, 14 deal with internal controls, 7 with site security, 7 with enforcement, 3 with States and Indian tribes, and 2 with new approaches to royalty management.

API strongly recommends that legislative and regulatory changes which may be promulgated as a consequence of the Commission's recommendations should reflect the practical realities of production field operations, that derived benefits should justify any additional cost, and that enforcement and sanctions should be dependent on the facts of the particular case and subject to judicial review on a de novo basis.

In this direction, API believes that it is essential that the government royalty management system accommodate the many changes of lessee which take place in normal industry operations just as other landowners do.. Some of the kinds of changes which can occur are illustrated in simplified fashion in Exhibit IV, hereto. Such changes must now be reported to and approved by the government but apparently do not always find their way into the USGS royalty management and accounting process. They should and industry should not be required to shoulder this responsibility of keeping track of the governments business.

API firmly supports the principle that there should be proper accountability for royalty payments based on all oil and gas produced including that from Federal and Indian lands. API believes the government's accounting system can and should be improved. API will work with the Congress and the Department of the Interior toward achieving fair and workable solutions to all clearly defined problems with royalty accountability. API's comments on the Commission's recommendations are directed to this end.

EXHIBIT I

EXAMPLES OF GAS PRICE DISPUTE

(This example involving Getty Oil Co., is taken from the Commission's hearing record to present one instance of how disagreements can occur on royalty determinations. Other different examples could be cited.)

Getty owns an undivided 50 percent interest in an oil and gas lease covering federal lands on the outer continental shelf in the Gulf of Mexico. In 1970 Getty entered into a gas purchase contract with an interstate pipeline company under which Getty agreed to sell to the pipeline company part of the gas produced from this lease. Getty also entered into an agreement with a wholly-owned subsidiary of Getty under which Getty agreed to sell part of the gas from this lease to the wholly-owned subsidiary at the same price which Getty received from the interstate pipeline purchaser. The USGS audited royalty payments made by Getty under this lease for the period from June 15, 1972 to December 31, 1977. As a result of this audit, the acting oil and gas supervisor, accounting, Gulf of Mexico Area, USGS, determined that Getty owed additional royalties on production from this lease in the amount of $484,329.47. This assessment was composed of three separate items. The largest was an item of $459,652.28 which the auditor for the USGS alleged was due on the premise that Getty should pay royalties on the gas it sold to its subsidiary at a value higher than the price which Getty received. Getty, however, did not agree with the assessment of $459,652.28 which it nevertheless was required to pay under protest. Getty appealed the $459,652.28 assessment. On October 31, 1980, the Office of Hearings and Appeals of the Department of the Interior reversed the decision assessing the $459,652.28 amount against Getty Oil Company and held that Getty had correctly valued and paid royalties on the gas it sold to its subsidiary from the lease in question. That decision became final and Getty filed a request for refund from the Department of the Interior.

EXHIBIT III

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REVISED 3/11/82

API
COMMENTS ON RECOMMENDATIONS

INTERNAL CONTROLS

1. Production Start-Up Notification

That the Department require an operator to notify it by telegram or equivalent means on the the first business day after new production begins on a lease. Failure to comply would subject the operator to a penalty equal to the value of the total production between the start of production and the date of notification, except in those rare cases when extenuating circumstances require an exception.

Comment

There is no need to impose this requirement. The USGS already requires that a Monthly Report of Operations (Form 9-329) be filed by each operator. This report shows all production from the lease. Form 9-329 therefore, does show the start of production, even though it may not be labelled "initial production" in the report. If the USGS desires that initial production be identified as such, this could be accomplished easily by requiring that the date production commences be reported on the Form 9-329 filed for the month in which production starts.

No useful purpose would be served by requiring that start of production be reported the following business day. Such a notice would neither accelerate the payment of, nor the accuracy of reporting, nor calculation of royalties. The accuracy of the reported royalties can be verified easily on audit by cross checking production reported to state regulatory bodies, together with records of the operator and the records of purchases of production.

Not only will this immediate notice of commencement of production requirement be an unnecessary administrative burden on the lease operator, but the penalty proposed for non-compliance is totally out of line. If the immediate notice requirement should be imposed, no penalty should be levied for inadvertent or non-willful failure to comply. In any event the penalty should be far less severe. A basic tenet of our legal system is that punishment should fit the crime. This recommendation calls for an 87½ percent penalty if notice is late, hardly commensurate with the violation.

EXHIBIT II

SELECTED AUDITS OF FEDERAL AND INDIAN LEASES

The eleven oil and gas audits summarized below were performed by the Office of Inspector General and its predecessor office. Other audits were performed on hard minerals. Substantial additional oil and gas royalty recoveries have been identified by lease reviews by the General Accounting Office and the Geological Survey. (Notes: These audits covered a period from 1972-1978. Implications that the royalties are uncollected/uncollectable are incorrect.)

Lessee	Audit Title	Major Problems Identified	Additional Royalties Identified	
TEXACO	Review of Royalties Paid on Residue Gas OCS Lease 0310, 1972-1976	Valuation of lessee-used Gas	$2,123,329	As a result of differing interpretations of the royalty payment provisions of OCS lease 0310, the USGS assessed an additional $2,123,329 royalty on residue gas that Texaco used in one of its refineries. The company paid $1,633,901 of this claim in February 1978 and posted bond for the remaining $489,428 pending appeal. After losing the appeal, Texaco paid the $489,428 plus $79,423 in interest during August 1979, satisfying the entire claim.
OCEAN	Review of Royalty Payments Made by Ocean Production Company (Ocean) on Natural Gas Removed from Federal OCS Leases G-1023 and G-1526, 1974-1977	Failure to report gas lost, injected, or used as fuel	$ 156,198	
MOBIL	Review of Royalty Payments Made by Mobil Oil Corporation (Mobil) on Natural Gas Removed from Federal OCS Leases G-2041, G-2045, G-2051, G-1440, 1973-1977	Valuation of gas sold	$ 24,634 (103,533)[1]	

Lessee	Audit Title	Major Problems Identified	Additional Royalties Identified	
GETTY	Review of Royalties Paid on Residue Gas, OCS Leases G-1752-1 and G-1752-2 Getty Oil Company, 1972-1977	Valuation of lessee-used gas	$ 484,329[2]	This money was not refunded until March 15, 1982, about a year and one half after decision by the Board of Appeals, and after the Commission report issued.
CABOT	Review of Royalty Payments on Natural Gas Removed from Federal Lease OCS G-0092, Block 273, Eugene Island, Offshore Louisiana, 1977-1978	Valuation of lessee-used gas	$ 684	
SUN	Review of Royalties Paid on Residue Gas, OCS Lease G-1752-3, Sun Oil Company, 1972-1978	Valuation of lessee-used gas	$ 245,086	Sun has sold this gas to a transmission company under an old contract through which it reserved the right to one-third of the gas for their own use. If Sun does not use the gas, it would go to the transmission company at the contract price - the price on which Sun had paid royalty. The USGS decided that a higher price should be used in royalty determination. In 1979, Sun paid the government $245,086.43 under protest and is currently paying the higher royalty also under protest.
AMOCO	Review of Royalty Payments Made by Amoco Production Company (Amoco) on Natural Gas Produced and Sold from OCS Leases 0572, 0575, 0578, and 0788, 1972-1978	Valuation of gas sold	$ 44,006	The audit report was in error - failing to take into account two payments. This has been acknowledged by USGS.
CHEVRON	Review of Royalties Paid on Gas Produced from OCS Leases 0373, 0374, 0375, 0377, 0378, G-1295, G-1297, G-1312, G-1367, G-1372, G-1373, G-1452, G-1623 and G-3338, Chevron USA, 1972-1978	Valuation of lessee-used gas	$7,621,755	In August of 1979, the USGS claimed additional royalties from Chevron in the amount of $7,621,755.34 as the result of an audit for the periods from Feb. 10, 1971 to March 12, 1971 and May, 1972 through April, 1978 on gas production from Main Pass Block 41 in the Gulf of Mexico. The primary question concerned the method of valuation of the gas. There never was any question of fraud, theft, or concealment of facts. Chevron appealed the matter to the Director of the USGS and the appeal is still pending.

Lessee	Audit Title	Major Problems Identified	Additional Royalties Identified	
TEXACO	Review of Royalties Paid by Texaco Inc., on Residue Gas from OCS Leases 0572, 0575, 0578, and 0788, 1972-1978	Valuation of lessee-used gas	$ 448,351	As a result of differing interpretation of the royalty payment provisions, the USGS assessed an additional $448,350 royalty on residue gas from OCS Leases 0572, 0575, 0578 and 0788 that Texaco used at one of its refineries. The company paid $109,167 of this claim in December, 1979 and posted bond for the remaining $339,183 to cover the appealed portion of the royalty demand. That appeal is pending before the Director of the USGS.
CONOCO	Review of Royalties Paid by Conoco, Inc. on Natural Gas Removed from Federal Leases	Improper valuation of gas due to the use of incorrect BTU values, failure to compare processed gas values to wellhead values, incorrectly valuing natural gas liquids, failure to file for the stripper well classification for some wells, and mathematical errors were reported.	$ 572,498	The underpayment in this instance essentially resulted from a difference of opinion as to "fair market value". The matter has been fully settled - no underpayment remains.
EL PASO	Review of Royalties Paid by El Paso Natural Gas Company on Natural Gas Removed from Federal and Indian Oil and Gas Leases	The pricing methodology applied by El Paso to production after June 1, 1977 should have been applied retroactively to June 21, 1974.	$10,044,243	Contrary to Commission's report, FERC ruled that company pricing methodology was correct, USGS disagrees - the company is in the middle.

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[1] Overvalued Gas Production

[2] Reversed by the Interior Board of Land Appeals and subsequently refunded by the USGS. The Office of the Solicitor did not represent the government at this hearing. This reversal may be appealed to the Secretary.

While the government should receive royalty payments from the first day of production, this recommendation may delay new production until the operator is certain the government has received proper notification.

2. Payor Plan

That the Department immediately require all lessees of revenue producing leases or their agent (the operator or some other agent) to submit a payor plan signed by all payors indicating the payment responsibilities of each party. In the payor plan, the lessee should identify the payors for 100 percent of the royalty obligation. Modified payor plans must be submitted whenever any payor responsibilities change. Upon receiving such changes, the Federal royalty managers should consider them as being proper unless they are later disapproved. Noncompliance with these requirements would subject the lessees to substantial penalties.

Comment

If it is the intent that the responsibility rest with the original lessee, due to the possibility of several transactions before drilling or production commences, it would prove to be administratively unfeasible. Surely, the original lessee would not be required to keep a record and give notice of future transactions of ownership in a lease in which the original lessee no longer has an interest.

The new royalty management program currently being developed and implemented provides that each payor of federal royalties also report sales and production and their percentage of the total royalty obligation for each lease. By combining these reports/payments it should be unnecessary to have a separate payor plan.

It should also be noted that not only would a prospective plan of this nature be very onerous, a retroactive application would probably prove to be nearly impossible for most of the industry.

Notification of changes in payment responsibility by current payors should be sufficient.

3. Lease Subaccounts

That the managers of the Federal royalty program complete in a timely fashion the installation of the new subaccount system in which each payor on a lease has an account, replacing the current system which features a statement of account by lease (but with multiple payors).

Comment

The API believes this is a positive step and eliminates the need for a payor plan as discussed in No. 2 above or an operator of record as discussed in No. 4 below.

4. Operator of Record

That the Federal royalty managers work toward the implementation of the concept of an "operator of record" for each lease and, where possible, a single payor; the operator of record would be responsible for maintaining all records related to the payment of royalties from that lease.

Each month after the payments are made, the operator of record would reconcile the payment with the production report, notify the Federal royalty managers of any discrepancies and the reasons for them, and provide the Federal royalty managers with the correct information. Where a single payor is possible, all payments for that lease would be made by one individual and all records kept by him.

Comment

To establish a single payor and/or to hold an "operator of record" responsible has three very serious problem areas:

A. Anti-trust violation problems are inherent in this proposal. Unless and until all parties involved in such "operator of record" activities are granted, by statute, complete immunity from anti-trust law violations by reason of activities required to comply with this proposal, this recommendation should not be considered.

B. Exchange of information necessary for compliance, i.e., BTU sales price, gathering allowance, manufacturing allowance, purchaser, and liquid value by product would have an anticompetitive effect. Most of this data is considered as proprietary by the various parties involved.

C. The additional administrative effort to gather/exchange such data would be very onerous and in many cases extremely difficult to obtain, and would be further complicated if the "fair market value" concept is introduced.

5. Use of Production Records

That the Federal royalty managers incorporate production data into the royalty management system in order to cross check the data with sales and royalty data for all leases each payment period. This should begin immediately on a systematic sampling basis even though it will have to be done manually.

Comment

This appears to be an activity internal to USGS. It should be noted, however, that independent sources of production data may not be reliable or complete and should be selected carefully and used judiciously. In addition, some of the production data, e.g., gas charts, does not necessarily belong to the operator but is the property of the purchaser. Ordinarily, the operator has access to such data for a period of two years and must return such data within 60 days from day of request for them.

7. Purchasers' Reports

That the Department seek legislation authorizing the Federal royalty managers to require that purchasers submit copies of their reports directly to the Federal royalty managers in a format prescribed by the royalty managers, and to impose civil penalties in the event of noncompliance. This authority would be exercised at least in those cases where there is no other government-required report provided by a party different from the payor covering that particular oil, gas, or other mineral taken from the lease for the same reporting period; and

That the Federal royalty managers systematically check these purchaser reports against reports submitted by the payor, at least on a sample basis.

Comment

This requirement should not extend beyond the first purchaser. It should be borne in mind that independent data, provided by the first purchaser, would not be available where intra-company movement is involved. Therefore, any substantiation of production data should be based on the company's internal records supporting such movement. Also, the new Minerals Management Service royalty reporting procedures require that MMS royalties be based on the lessee's entitlement of gas available for sale and not on the actual deliveries to the purchaser. This factor will add considerably to the effort of reconciliation of purchaser volumes to producer reports.

In an agency already heavily loaded with paperwork, this recommendation seems of dubious merit. To establish a cradle-to-grave accounting system for oil goes far beyond royalty collection problems and takes into account neither the inherent suffocating reporting requirements nor that the oil produced from Federal and Indian leases is basically fungible and difficult to differentiate. this same reasoning applies to the Commission's Site Security recommendation (#7, Undocumented Oil) to require purchasers, up to and including refiners, to document from whom they purchase oil and from what lease.

8. Channels of Commerce Study

That the Secretary request the Inspector General to lead a study of alternatives to purchasers' statements for the purpose of cross checking oil and gas sales in cases where there may be collusion between purchasers and sellers. The study should include an evaluation of the usefulness and legal complexities of tracing minerals through channels of commerce to processors or major end users, not just to first purchasers, as an ultimate cross check on production, sales, and royalty reports.

Comment

Any attempt to trace oil or gas from a specific property through the many sales and/or exchanges through the various channels of commerce would be extremely difficult, complex, and burdensome, if not impossible. So long as proper documentation is furnished as oil or gas leaves the lease, or at the point of first sale, any further efforts to track the oil or gas on a property basis would not enhance the accountability for accurate royalty settlements.

10. Product Valuation Guidance

That within five months after the filing of the Commission's report, Federal royalty managers decide what issues related to fair market value and other product value matters must be settled by the Department before more definitive guidance can be provided to the industry, and determine what issues can be settled by the royalty managers alone;

That by January 1, 1983, the Federal royalty managers provide preliminary guidance to the industry on the issues identified for resolution without significant Departmental participation; and

That by July 1, 1983, the Federal royalty managers issue detailed guidance to industry covering both sets of issues.

Comment

"Fair market value" is an economic and legal concept which involves contract terms, government regulations, the time of sale and other factors. It would be impossible for any party to develop a precise definition which could be adequately applied to the variety of situations which arise. If this recommendation contemplates empowering the USGS to promulgate a binding definition or formula, it is strongly opposed. Disputes can, and should, be resolved by the courts which are experienced in weighing the various factors involved in market value determinations.

12. Offshore Refunds

That the Secretary urge the Congress to change the time-consuming process which the industry must go through to obtain refunds of royalty overpayments on offshore leases.

Comment

We believe this is a positive step and support it. Consideration should be given to allowing payors to offset overpayments against future royalty payments.

13. Interest Rates

That the Federal royalty managers continue charging at least the "current value of funds rate" established quarterly by the U.S. Treasury for late payments or underpayments.

Comment

We strongly believe interest rates should never exceed the current prime rate and should be applied only to the actual number of days a payment is late as opposed to a full month's interest.

14. 60 Day Payment for Gas

That the Federal royalty managers allow 60 days for payment of royalties for natural gas after the end of the month in which the gas is used, sold, or removed from the lease. This policy would be consistent with present industry practice.

Comment

We support the recommendation as it recognizes the realities of industry operations. It should result in substantial time savings for both the industry and Minerals Management Service.

15. Accelerated Look-Back Audits

That the Department carry out the first 25 look-back audits on an accelerated schedule with completion no later than the end of calendar year 1983, and that audits of companies in addition to the first 25 be initiated as soon as possible, but no later than the end of the calendar year 1983.

Comment

In determining the period for audit, consideration should be given to the availability of all the pertinent data. As stated in (5) Use of Production Records, operator is contractually limited to access to gas charts, which are the purchaser's property, for a period of 2 years. Consequently, Look-Back audits should generally be restricted to a 2-year time frame. We are concerned that remedial action will be taken before the scope and extent of the problem can be determined. These look-back audits should provide sufficient and correct data for informed decision-making to avoid rushed and ill-advised regulatory or legislative action.

17. Account Reconciliation

That the managers of the Federal royalty program develop a definitive plan for choosing lease accounts for reconciliation. This should be based on a reasonable method for determining which accounts on leases (or groups of leases, such as in units) it would be most beneficial to pursue in detail. Because account balances are unreliable indicators, they should not serve as the sole basis for this selection. The plan should be developed and initial analyses begun without delay. Look-back audits should not be considered an alternative to lease account reconciliations.

Comment

Lease accounts as acknowledged by the Commission are so inaccurate and inadequate, we do not believe they should be used to determine any current royalty deficiency problems.

20. Certified Public Accountants

That the Secretary consult with the American Institute of Certified Public Accountants to arrange for professional services by the companies' certified public accountants with respect to the adequacy of the internal controls and accounting for royalty payments, either through an extension of the CPA's regular auditing procedures or through separate engagements; and

That the Secretary consider including a requirement for such professional services in future leases and regulations.

Comment

Insofar as requiring external CPA's to express an opinion on the adequacy of controls related to royalty payments, we do not feel this is an appropriate extension of their customary annual reviews. The purpose of their normal examination is to enable the auditors to form an opinion as to whether the financial statements, taken on a whole, present fairly the financial position, results of operations, and changes in financial position in accordance with generally accepted accounting principles. It is not intended to provide assurance as to individual accounts or items within the financial statements. A separate audit for the purpose of expressing an opinion on royalty payments, in our opinion, could not be supported from a cost/benefit analysis and would probably be misleading to the public in general without an inordinate amount of audit work.

SITE SECURITY

1. Departmental Policy

That the Secretary reaffirm by a letter to all operator and lease operators that the Department holds them responsible for security on Federal and Indian lease sites and that the Department will conduct an active enforcement program to assure that their site security responsibilities are carried out in a satisfactory manner.

Comment

We agree with the Commission that the operator should have primary responsibility for security on Federal and Indian lease sites. Most companies will have already adopted a security program. It should be noted that the lessee will normally lose several times the value of the royalty oil, if oil is stolen from a lease operated by such lessee.

2. Site Security Plans

That all operators on Federal and Indian lands be required by regulation to develop lease site security plans detailing how that operator will carry out his responsibility to ensure security of the site. These plans would be required to be consistent with minimum government standards and would be submitted to the managers of the Federal royalty program.

Comment

Lease security plans will necessarily vary according to the location or area such as onshore or offshore, type production method, flowing or artificial lift and means for removing production by truck or by pipeline after automatic custody transfer. Therefore, any minimum standards developed by DOI must be very general in nature and must be subjected to review and input by the industry. We contemplate that company security plans would be applicable to their overall operations and not be site specific which would be burdensome to both DOI and industry.

Regulations should reflect the magnitude of securing every producing well from determined thieves. Unfortunately, production on Federal and Indian leases is not in a compact area; the sheer size and remoteness of the areas involved initially place security efforts a giant step behind those intent on stealing the product. Industry should have a voice from the inception in crafting guidelines to assure that government drafters understand the magnitude of the problem addressed. Any guidelines should reserve wide latitude for each operator who knows what security measure scan best protect his investment.

3. Revised Regulations

That USGS regulatory requirements be revised to eliminate any detailed regulatory requirements for site security and require instead that operators take the necessary steps to provide for site security as well as to meet minimum standards. Both requirements must be incorporated by operators into all site security plans. Deviations from these minimum requirements would be permitted on a case-by-case basis by the Federal royalty managers. Noncompliance with the principal requirements of the plan proposed and agreed to by the operator would be prima facie evidence of noncompliance with the Federal regulations. Noncompliance with the minimum requirements would also be a violation. Both violations would be subject to substantial penalties. The requirements of the new regulations would be phased in during a transition period.

Comment

No detailed regulations nor site specific requirements should be imposed by DOI. The operator should only be required to comply with the plan proposed by it and the minimum requirements developed by DOI where applicable. Variances from the DOI minimum requirements should be allowed on a case-by-case basis. Sanctions for noncompliance of either the proposed plan or the minimum requirements should be imposed only after notice and reasonable time for correcting any alleged violations.

4. Run Tickets

That the Department seek legislation or publish regulations, as necessary, to require truck haulers of oil to have run tickets in their possession at all times while transporting oil from Federal and Indian leases.

Comment

We agree that truck haulers removing oil from a Federal or Indian lease should be required to have a run ticket for the particular oil in the truck at any time.

5. Expand Inspectors' Authority

That the Department seek legislation to empower Federal inspectors (within constitutional limits) to stop trucks in order to check that the truck hauler possesses a run ticket.

Comment

We agree with empowering Federal inspectors to stop trucks to check for the pertinent run ticket as long as controls are instituted to prevent harassment.

6. State and Local Enforcement

That the Federal government establish cooperative relationships with State and local enforcement officials and encourage them to use their authority to inspect for run tickets in the possession of haulers of oil and to deter oil theft generally.

Comment

We agree with this recommendation as long as controls are instituted to prevent harassment.

7. Undocumented Oil

That the Department seek Federal legislation to prohibit the purchase of undocumented crude oil and require purchasers of crude oil up to and including refiners to keep documentation showing from whom they purchased the product and from what lease or unit.

Comment

We agree that all oil custody transfers should be supported by proper documentation; however, to attempt to show the original lease or unit from which the oil was produced is entirely unreasonable, if not impossible, and serves no useful purpose past the point of first purchase. See comment on Internal Controls Recommendation No. 7, Purchasers Reports.

ENFORCEMENT

1. Inspection/Enforcement Strategy

That the Federal royalty managers design and implement an inspection/enforcement strategy which will assure that the performance of the industry, both in assuring site security and in reporting production volumes, is properly monitored. This strategy should include how often and in what manner the field staff will inspect sites, how violations will be determined and penalties assessed, what other methods will be used to ensure site security and to verify production on site, and how the managers of the Federal royalty program will use the program's resources, both present and future, to carry out this strategy. To implement the strategy the Department should:

Increase the number of Federal inspectors so that at a minimum each Federal and Indian lease can be inspected once a year for site security and production verification purposes. (A minimum of 83 inspectors devoting 100 percent of their time to these two duties.)

Increase the frequency of inspection beyond the once a year minimum, by entering into cooperative agreements with States and Indian tribes and by using contractors as necessary to assist with the monitoring of the site.

Comment

The regulatory strategy discussed in the first paragraph must be subjected to full review and input from industry, and must be clear in regard to determination of violations, procedures for assessment of penalties, and methods for ensuring security and verification of production on site. If contractors are used for inspection, a method for identification and notice must be provided to the operator. Controls should be provided to prevent harassment and duplication of authority.

2. Fair But Firm Enforcement

That the Secretary direct employees of the Federal royalty program that he expects enforcement of the program's regulations to be conducted fairly, but firmly, with penalties imposed when violations are found.

Comment

We agree with proper regulations, fairly administered. However, we do not agree that penalties should be strict liability as implied by the final phrase of this recommendation. Penalties should not necessarily be automatic but imposed only after notice with a reasonable time frame allowed for compliance.

3. Civil Penalties: Site Security

That the Department seek legal authority to assess civil penalties for site security violations. The civil penalty system should have fines up to $10,000 per violation, and under certain circumstances, each day should be counted as a separate violation.

After the legislation is enacted, appropriate criteria for levying fines should be developed and promulgated after publication in the *Federal Register* for review and comment.

These criteria should include the operator's history of violations, the potential for theft, negligence of the operator, and good faith in compliance. Civil penalties should be imposed both for violations detected for the first time and for noncompliance, that is, failure to obey an order.

Comment

We contend that the penalty or size of fine for a violation must consider the overall situation such as likelihood of a theft occurring, possibility of an underpayment of royalty, the methods of measurement, and culpability of the operator and then scaled accordingly.

The sanctions should not be strict liability but should be imposed only after notice with reasonable period allowed for compliance.

4. Civil Penalties: Payments

That the Department seek legal authority for a civil penalty system for nonpayments, late payments, underpayments, error ridden reports, and failure to submit or update the required payor plan.

The Internal Revenue Service's system of a sliding penalty scale based on the culpability of the payor and harm to the government could be used as a model. As applied to royalty collections, this would provide that failure to report would result in a penalty of 5 percent per month of the royalty owed up to a maximum of 25 percent, unless the payor shows that his failure to report is due to reasonable cause and not willful neglect. Chronically error ridden reports would be treated as a failure to report.

Also, there should be a penalty for failure to pay the royalty when due of one-half of one percent per month of the amount owed, up to a maximum of 25 percent.

Where underreporting represents 25 percent or more of the amount owed and is willful, the USGS should impose a civil penalty of 50 percent of the total unpaid royalties due. Penalties would be applied in addition to interest levied on the delinquent royalties.

Comment

The concept of civil penalties should be considered very carefully, penalties certainly should not be imposed in cases of inadvertent or unintentional errors or bona fide valuation disputes. Willful or intentional underpayments or non-payments would justify a penalty. The imposition of penalties for "error ridden reports" would be totally unfair unless the term "error ridden reports" is defined so that a reporting party understands clearly the standard required.

Any guidelines concerning the assessment of penalties relating to royalty underpayments should also consider the magnitude and value of overpayments.

5. Shut-in: Site Security

That the Federal royalty managers use shut-in authority in cases of noncompliance where there is serious potential for theft. Operators should be charged the value of the average daily royalty that otherwise would have been paid had the lease not been shut-in, as liquidated damages or penalty.

Comment

This recommendation would place severe sanction authority under the Federal royalty manager. This authority must be exercised only at the highest level with full notice to the lessee. Constitutional protections for both individual and corporate lessees must be ensured. Therefore, a clear showing that there is a serious potential for theft must be made before a shut-in is imposed. Moreover, the use of such shut-in authority as a penalty must be exercised very judiciously because of possible reservoir damage as well as protection for lessees' correlative rights. Finally, the proposed penalty seems excessive in view of the contemplated offense.

6. Shut-in: Underpayments

That the Secretary of the Interior exercise his authority to use shut-ins and lease cancellations as sanctions for severe cases of underpayments. Operators should be charged the value of the average daily royalty that would otherwise have been paid had the lease not been shut-in, as liquidated damages or penalty.

Comments

(See comments under No. 5, above). There must be a clear showing of knowing and willful underpayment of royalties, in fact, before either shut-in or cancellation of a lease is considered. This decision must be made at the Secretary of Interior level only after notice to the lessee with opportunity to resolve any alleged underpayments. Any liquidated damages must be based upon proven underpayments only.

7. Lease Cancellation

That the Secretary pursue lease cancellation in cases of repeated theft or serious lease security problems.

Comment

(See comments under Nos. 5 and 6). The lessees' Constitutional due process rights must be assured if cancellation of a lease is being considered. This would include notice to the lessee with opportunity to oppose such lease cancellation, both administratively and judicially.

Where such sanctions are being considered, concurrent notice should be given by the Federal Authority to all participants concerned in the property. Such participants should have the right of redress if operator had failed to inform them of any impending sanctions.

STATES AND INDIAN TRIBES

1. Expanded Policy

That the Secretary announce an expanded policy of cooperation with States and Indian tribes in the royalty management area--namely, that the Department will share information and royalty management functions (including inspections) with affected States and Indian tribes to the maximum extent possible, consistent with its responsibility to assure the proper accountability of the royalties paid on minerals removed from Federal and Indian lands.

Comment

An expanded policy of cooperation with states and Indian tribes is appropriate so long as cooperative agreements for the sharing of "information and royalty management functions (including inspections)" specifically negate:

needless duplication of inspections and operating requirements,

subjecting operators to concurrent direction from federal, state, and/or Indian authorities,

creation of practices or standards more severe than called for by federal regulations or directives, and

protection of proprietary right as to production/drilling/completion, etc., data of lessee/operator.

3. Immediate Implementation

That the Secretary immediately take steps to assist States and tribes in carrying out certain royalty management functions, by:

Offering to enter into demonstration cooperative agreements with interested States and Indian tribes, especially for inspection of leases, audits, and training and to participate in the funding where appropriate.

Providing for increased technical support of Indian royalty management activities through the BIA's Division of Energy Minerals in the Office of Trust Responsibilities and (since Osage Tribe activities are budgeted separately from those of other tribal and Federal leases) assuring that the Osage Tribe has inspectors adequate to conduct inspections for site security and production verification at each lease at least once a year.

Seeking legislation as necessary to enhance a State's or Indian tribe's ability to carry out royalty management and site security functions under cooperative agreements with the Department. Specifically, the program should authorize the enforcement of all applicable Federal laws and regulations by States and tribes (operating under a cooperative agreement with the Department) and their obtaining information from companies and others to the same extent as if they were employees of the Department. Any cooperative agreements should provide for the transfer of funds to the States and Indian tribes for an appropriate portion of the costs, based on the source of the funds and the respective responsibilities of the parties.

Comment

The remarks made under Expanded Policy (1. above) are pertinent and applicable to this heading.

We have particular concern with the last recommendation under this heading which would authorize enforcement "--- of all applicable federal laws and regulations by states and tribes --- and their obtaining information from companies and others to the same extent as if they were employees of the Department." This recommendation not only raises the specter of states and tribes raising extraneous legal and regulatory matters but also suggests granting authority for burdening operators with both duplicative and special reports.

7. Sharing Penalties and Interest

That the Federal government share with the States and Indian tribes both interest and penalties paid for late payments and underpayments.

Comment

The sharing of both interest and penalties should be limited to the State or Indian tribe that has suffered the respective late or underpayments.

NEW APPROACHES TO ROYALTY MANAGEMENT

8. Windfall Profit Tax

That the Department requests the assistance of IRS to revise its regulations or design a legislative change which would relieve the

Federal royalty program of the responsibility of calculating and paying the Windfall Profit Tax on royalty in-kind transactions; and

That the responsibility for calculating, withholding, and paying the Windfall Profit Tax on all crude oil sold on Federal leases be returned to the industry, with oversight by the IRS rather than the Federal royalty management program.

Comment

It should be recognized that the operator or lessee of a property on which royalty oil is taken-in-kind cannot withhold the tax since they are not involved in the proceeds of the sale. This responsibility must remain between the buyer and the seller. However, since half the royalties received by the USGS are taken "in kind" the extra burden of paying Windfall Profit Tax on all royalties collected would not offset control benefits over substantial monetary sums and therefore should remain the responsibility of the Federal royalty manager.

9. Increased Royalty Rate

That the Secretary take the necessary steps to implement the use of a minimum royalty rate of 16-2/3 percent for new or renegotiated oil and gas leases, except where requested not to do so by an Indian tribe or Indian landowner.

Comment

According to its official charter The Commission was to:

a. Examine the allegations of waste and loss of minerals royalty revenues due the Federal Government, States and Indian tribes;

b. Evaluate and recommend improvements to the Department's royalty management system, and

c. Recommend improvements in the interal controls in areas related to revenues generated from Federal and Indian lands.

The recommendation to increase the royalty rate appears to be outside the scope of the Commission's charter. Further, the evidence received by the Commission was directed towards the problems of theft and mismanagement. The evidence shoudl not serve as a basis for recommending an increased royalty.

The Commission's recommendation fails to take into account fundamental differences between leases which are under the competitive bidding system (Indian and offshore) and the vast majority of onshore leases which are under a non-competitive system. It fails to recognize the disincentive which higher royalties would have on exploration in onshore frontier areas and on the development and maintenance of production on marginal properties.

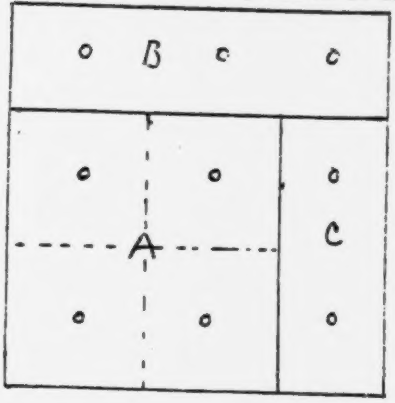
An increase in the onshore royalty rate is an action with far-reaching economic impacts which should only be taken, if at all, after public hearings and specific and detailed studies of the issue. The nexus between higher royalty rates and better royalty management is a specious one at best. One of the reasons royalties from federal lands have risen from $500 million in 1971 to more than $4 billion in 1981 is financial incentive to drill in the form of decontrolled prices. Energy exploration has shown unprecedented growth during the last year, and according to the Commission's own figures, federal royalties should increase to $14 billion in 1990. Raising royalty rates is merely another form of price control and a step backward in this Nation's journey toward energy self-sufficienty.

DG/slc
202/G

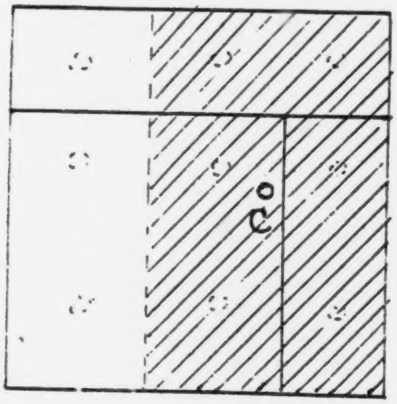
EXHIBIT IV

CHANGES IN OPERATING RIGHTS

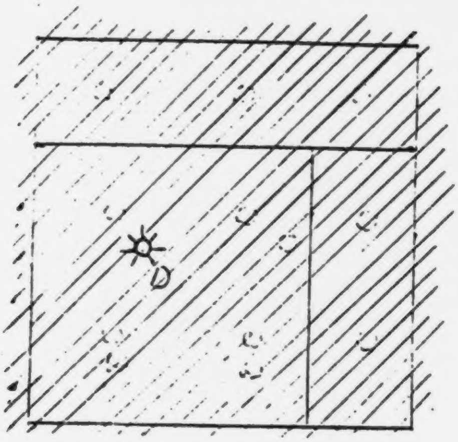
(The changes illustrated here are reported to and must be approved by the Bureau of Land Management. These changes must be conveyed to USGS if any lease account system is to work.)



This represents a part of an oil field, drilled several years ago to a shallow depth (5,000). A, B, and C are all operators of their leases. A, 3, and C pay royalties on oil and associated gas production from their leases.



C wants to drill a deep oil well. A and B assigned operating rights to oil and gas found between 6,000 and 12,000 ft. (shown by the shaded portion of their leases). C is operator and would normally pay royalty on production between 6,000 and 12,000 ft. beneath the shaded areas. However, in many instances A and/or B might take their oil or gas in kind for their gross working interest (includes the royalty), sell it, and then, in turn, pay the royalty. In some instances A and/or B simply get paid their gross working interest and then pay the royalties themselves.



A neighboring operator, D, now wants to drill an 18,000 ft. gas prospect. A, B, and C contribute operating rights to oil and gas found below 12,000 ft. D is operator and can pay royalty on production below 12,000 ft. However, gas production is usually taken in kind whereby A, B, C, and D would dispose of their own share of gas and each pay their own royalties.

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May 11, 1982

HAND CARRIED

The Honorable William S. Cohen
Chairman
Senate Select Committee for Indian
  Affairs
1251 Dirksen
Washington, D.C. 20510

Attention: Aaron Hostyk

Re: S. 2305

Dear Senator Cohen:

In response to your letter of May 4, 1982, we submit these comments on S. 2305 on behalf of the Three Affiliated Tribes of the Ft. Berthold Reservation. In general, the tribes support the bill as a step toward improving the royalty collection process and increasing federal-tribal cooperation for the management of Indian mineral resources. However, S. 2305 is not as good a step in that direction as is its House counterpart, H.R. 5121, the substitute bill recently reported out by the Mines and Mining Subcommittee of the House Interior Committee. Primarily, this is because the responsibilities placed on the Secretary under the House bill are mandatory. Those detailed in S. 2305 are discretionary. For example, Section 4(a) of S. 2305 provides that the Secretary "may" prescribe rules and regulations for the proper determination and collection of royalties. The corresponding provision of H.R. 5121, Section 102, provides that the Secretary "shall" prescribe regulations.

Our specific technical suggestions with respect to S. 2305 are reflected in red in the attached copy of the bill. The pencil notations in the left hand margin refer to comparable provisions of H.R. 5121. Specifically, our comments on the various sections of the Senate bill are addressed to the following points:

Section 3 -- Definitions.

The definition of federal land should expressly exclude Indian land. The definition of Indian land should be broadened to include lands in which Indian allottees or tribes own the mineral estate, but not the surface estate. In general, such lands are treated as Indian lands and the provisions for security and proper royalty collection should apply with equal force in such instances. The definition of "Indian tribe" should be revised to conform with the definition used under the Natural Gas Policy Act, § 106(b).

Section 5 -- Duties of Interest Holders, Lessees, and Motor Vehicle Transporters.

Language should be added to make it clear that the time and manner provided for royalty payments specified by the Secretary will not override express lease provisions to the contrary. For example, some tribal leases are now making provision for electronic transfer of funds.

Section 6 -- Hearings and Investigations.

Subsection C(2) should be revised slightly for the sake of internal consistency and Subsection (d)(1) should refer to the rights of Indian tribes as well as the Secretary since tribes may have regulations or lease clauses which provide for certain rights of inspection and entry on the lease premises. Subsection (d)(3) should be revised slightly to make it clear that states and tribal enforcement officials acting pursuant to cooperative agreements shall have the right to enter upon or travel across any lease site.

Section 7 -- Injunction and Specific Enforcement Authority

Subsection 7(a) should be amended to include states and Indian tribes in the parties able to bring civil actions to enforce the act. This is consistent with the other provisions of the act and will add to the vigorous enforcement which the act contemplates. In order to accomplish this without granting overbroadly authority, it is necessary to revise Subsection (a) and insert a new Subsection (b) which allows only the Attorney General or his designate to bring civil actions to compel enforcement of mineral leasing laws in general.

Section 15 -- Civil Penalties.

Subsection (c) should contain a savings clause to make it clear that interest and penalties collected under this provision will not invalidate a lease clause which expressly provides for the payment of interest. Some Indian leases already call for interest and penalties for late payment at rates substantially above those provided for in the bill. We further suggest that the subsection be revised merely to provide for interest at an appropriate rate. As the Section is written, it is not as effective as existing regulations (30 C.F.R. § 231.80) which provide for interest on late payments or underpayments at a rate adjusted quarterly on the basis of the preceding quarter's cost of borrowing for federal funds. The subsection, as now drafted, would provide for an annual adjustment of the interest rate which might be a disincentive to prompt payment if, for example, interest rates increased substantially after the annual rate was determined. Further, the interest payments should apply to all late payments under a lease, not just royalties. Finally, a new subsection should be added to make it clear that interest and penalties assessed on Indian leases shall be paid to the tribe or allottees whose leases are affected by the violation or late payment for which the penalty or interest is assessed.

Section 18 -- Cooperative Agreements.

Subsection (b), applying to Indian tribes, should be amended to track language of Subsection (a). There is no reason to limit the section as it applies to tribes since Indian lands are specifically mentioned in Section 6.

Section 19 -- Relation to Other Laws.

It is very important to include a savings clause in this provision so that the act is not held to be a preemption by the federal government of existing authority and rights which Indian tribes or allottees may have under leases or pursuant to valid tribal regulations.

Section 20 -- Funding.

This provision should be deleted. Its effect is to exact a charge from Indians for the fulfillment of the United States' basic governmental and trust responsibilities. The treaties and statutes under which trust responsibilities were established do not contemplate such a charge. Surely, no segment of the population, never mind one of the neediest, should be directly charged for basic governmental services such as the writing of federal regulations.

To the extent that the provision seems to contemplate that deductions in future years will be adjusted to make up for deficits in prior years it is completely unfair. First, in the case of Indians (as opposed to states) royalty holders change from one year to the next. Thus, royalty holders could be charged for services which they never received.

Section 20, which contemplates deductions from Indian royalties, is very broadly written in terms of the costs which are to be covered by the deductions. However, Section 18(c) which contemplates reimbursements to tribes for taking over federal responsibilities is narrowly written to allow reimbursement only for costs "which are directly required to carry out the agreed upon activities."

On this point, it is also interesting to note how the language of the bill varies from the intent of the Linowes' Commission whose recommendations are embodied in the proposed legislation. Chairman Linowes, testifying before the Committee on Energy and Natural Resources, stated that "the Commission also recommends the creation of a self-sustaining fund to pay for 'extra audits and inspections beyond those included in the regular budget'". Section 20 is not at all imited to extra audits and inspections, but includes every conceivable royalty management activity. Chairman Linowes noted this difference and commented that Section 20, as now drafted, defeats the basic purpose for the Committee's recommendation. Further, Section 20 does not create a self-sustaining fund because royalty deductions are deposited into general revenues of the Treasury as a technical matter. To the extent that Section 20 requires a deduction only after payment of windfall profits taxes, it will result in higher percentage deductions for Indians which, unlike the federal government, are not subject to windfall profits taxes. If a self-sustaining fund is required to fund specific collection and management functions, the fund should be financed through fees levied against lessees, which is related to the services rendered. It is the lessees (and the government), not the Indians, who are responsible for the deficiencies and abuses in the present system, and it is the lessees who acquire up to seven-eighths of all production.

Finally, as noted above, H.R. 5121 is in general a better bill than S. 2305. However, one key provision of S. 2305, not contained in H.R. 5121, is the provision on valuation of production, Section 11(a). One of the primary problems with Indian (and no doubt federal) leases over the years has been the failure of the United States to properly value production. Thus, if H.R. 5121 is adopted by Congress, the section on Valuation from S. 2305 should be added.

We hope these comments are helpful. If you have any questions, please do not hesitate to contact us.

Sincerely,

WILKINSON, CRAGUN & BARKER
Patricia L. Brown
By: Patricia L. Brown

Enclosure

cc: Mr. Hugh Baker